

MASTER LIMITED PARTNERSHIPS

HEARINGS
BEFORE THE
SUBCOMMITTEE ON
SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDREDTH CONGRESS

FIRST SESSION

JUNE 30; JULY 1, 1987

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CONTENTS

Press release announcing the hearings	Page 2
WITNESSES	
U.S. Department of the Treasury, J. Roger Mentz, Assistant Secretary for Tax Policy	7
American Bar Association, Section of Taxation, John B. Jones, Jr., and Stanley Blend	62
American Institute of Certified Public Accountants, Tax Division, Herbert J. Lerner	68
Andrews & Kurth, Barksdale Hortenstine	128
Apache Corp., Edwin E. Cain and Michael Valdez	269
Ballentine, J. Gregory, ENSERCH Corp., Goldman, Sachs & Co., and Merrill Lynch & Co., Inc.	256
Barber, Alan T., Coopers & Lybrand	205
Blend, Stanley, Section of Taxation, American Bar Association	62
Cain, Edwin E., Apache Corp	269
Capone, Mark, International Paper Co.	324
Chapoton, John E., ENSERCH Corp., Goldman, Sachs & Co., and Merrill Lynch & Co.	256
Coalition for Publicly Traded Partnerships, James F. Dickason	159
Cohen, Richard G., Winthrop, Stimson, Putnam & Roberts	314
Commonwealth Financial Group, Commonwealth Mortgage of America, L.P., R. Dwayne Whitehead	314
Coopers & Lybrand, James R. Lovett, John S. Furst, and Alan T. Barber	205
Davis, Christopher L., Investment Partnership Association	167
Dean Witter Reynolds, Inc., Edward C. Oelsner III	211
Dickason, James F., Coalition for Publicly Traded Partnerships	159
E.F. Hutton & Co., Inc., William P. Nicoletti	223
ENSERCH Corp., John E. Chapoton and J. Gregory Ballentine	256
EQK Partners, Myles H. Tanenbaum	316
Furst, John S., Coopers & Lybrand	205
Goldman, Sachs & Co., John E. Chapoton and J. Gregory Ballentine	256
Hortenstine, Barksdale, Andrews & Kurth	128
International Paper Co., John T. Leyden and Mark Capone	324
Interstate General Co. L.P., James J. Wilson	337
Investment Partnership Association, Christopher L. Davis and William Morris	167
Jones, John B., Jr., Section of Taxation, American Bar Association	62
King & Spalding, William S. McKee and Mark A. Kuller	107
Kuller, Mark A., King & Spalding	107
Laventhol & Horwath, Robert D. Milburn	234
Lee, John W., Marshall-Wythe School of Law, College of William and Mary	340
Lerner, Herbert J., Tax Division, American Institute of Certified Public Accountants	68
Leyden, John T., International Paper Co.	324
Lollar, John H., Transco Exploration Co., Transco Energy Co., Transco Exploration Partners, Ltd.	283
Lovett, James R., Coopers & Lybrand	205
McKee, William S., King & Spalding	107
Merrill Lynch & Co., Inc., John E. Chapoton and J. Gregory Ballentine	256
Milburn, Robert D., Laventhol & Horwath	234

IV

	Page
Morris, William, Investment Partnership Association	167
National Apartment Association, Lewis H. Sandler	353
National Association of Realtors, Jeffrey R. Rosenthal	360
Neafsey, John P., Sun Co., Inc	276
New York State Bar Association, Tax Section, Donald Schapiro	79
Nicoletti, William P., E.F. Hutton & Co., Inc	223
Oelsner, Edward C., III, Dean Witter Reynolds, Inc	211
Peat Marwick Main & Co., George J. Robinson	241
Real Estate Securities and Syndication Institute, Jeffrey R. Rosenthal	360
Robert A. Stanger & Co., Robert A. Stanger	194
Robinson, George J., Peat Marwick Main & Co.	241
Rosenthal, Jeffrey R., National Association of Realtors and Real Estate Securities and Syndication Institute	360
Sandler, Lewis H., Southwest Realty Ltd., and National Apartment Association	353
Schapiro, Donald, Tax Section, New York State Bar Association	79
Southwest Realty Ltd., Lewis H. Sandler	353
Spiegel, Hart H., Brobeck, Phleger & Harrison	93
Stanger, Robert A., Robert A. Stanger & Co	194
Sun Co., Inc., John P. Neafsey	276
Tanenbaum, Myles H., EQK Partners	316
Transco Energy Co., Transco Exploration Co., Transco Exploration Partners, Ltd., John H. Lollar	283
Turlington, R. Donald, Brown & Wood	141
Valdez, Michael, Apache Corp.	269
Whitehead, R. Dwayne, Commonwealth Mortgage of America, L.P., Commonwealth Financial Group	314
Wilson, James J., Interstate General Co. L.P	337

SUBMISSIONS FOR THE RECORD

Arthur Andersen & Co., Richard A. Gordon, statement and attachment	378
Freeport-McMoran, Inc., James R. Moffett, statement	388
International Council of Shopping Centers, Wallace R. Woodbury, statement ...	392
Santa Fe Pacific Exploration Co., statement	395
ServiceMaster Limited Partnership, C. William Pollard, statement	396
Standard Pacific, L.P., Robert J. St. Lawrence, statement	401

MASTER LIMITED PARTNERSHIPS

TUESDAY, JUNE 30, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
TUESDAY, JUNE 2, 1987

PRESS RELEASE #4
SUBCOMMITTEE ON SELECT REVENUE
MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON THE ISSUE OF MASTER LIMITED PARTNERSHIPS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold public hearings on Tuesday, June 30, and Wednesday, July 1, 1987, on the issue of master limited partnerships beginning at 10:00 a.m. each day in room 1100 Longworth House Office Building.

These hearings are a continuation of a series of hearings on issues relating to pass-through entities begun in June of 1986. It is expected that the Subcommittee will hold additional hearings later this year on issues related to the provisions of Subchapter K of the Internal Revenue Code, including their application to master limited partnerships. Specific dates for these additional hearings will be announced at a later date.

In the first of these hearings, the Subcommittee will review the application of current law rules to master limited partnerships. Particular emphasis will be placed on the impact of the Tax Reform Act of 1986 on the use and nature of master limited partnerships. The Subcommittee will analyze the reasons for any changes in taxpayer behavior in light of the 1986 Act and the implications such changes may have regarding projected revenue collections from the corporate sector.

The Subcommittee hearings will also focus on the application of Code section 7701 classification regulations to master limited partnerships, as well as alternative proposals for classification standards. In addition, the Subcommittee will analyze the extent to which other forms of partial integration, currently permitted by the Internal Revenue Code, apply in determining the appropriate taxation of master limited partnerships.

The Treasury Department is expected to be the first witness. Public testimony is invited.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than Tuesday, June 16, 1987, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings (see formatting requirements below). This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their

-2-

prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies by the close of business, Wednesday, July 15, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

SEE FORMATTING REQUIREMENTS BELOW:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * *

*** NOTICE--CHANGE IN TIME ***

FOR IMMEDIATE RELEASE
THURSDAY, JUNE 18, 1987

PRESS RELEASE #4--REVISED
SUBCOMMITTEE ON SELECT REVENUE
MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A CHANGE IN TIME OF THE JUNE 30, 1987,
SUBCOMMITTEE HEARING ON THE
ISSUE OF MASTER LIMITED PARTNERSHIPS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a change in the time of the hearing scheduled for June 30, 1987, on the issue of master limited partnerships. The June 30, 1987, hearing will now begin at 9:30 a.m., instead of 10:00 a.m., in room 1100 Longworth House Office Building.

All other details concerning the June 30 and July 1, 1987, hearings remain the same (see Press Release #4, dated June 2, 1987).

* * * * *

Chairman RANGEL. We'll be opening up the hearings, and I apologize for being late.

Today our subcommittee will continue its series of hearings to study the treatment of various passthrough entities established under our tax laws. On June 9, 1986, we held the first series which was designed to provide a broad overview of tax policy issues affecting passthrough entities, and today and tomorrow we continue to focus on the issue of master limited partnerships.

The issue of the proper treatment of the so-called MLPs is one which presents the subcommittee with several policy, revenue and technical concerns. From a policy standpoint the tax laws have treated businesses conducted as partnerships differently from those conducted as corporations. Whether the master limited partnership form blurs the distinction between partnership or corporate forms and whether the MLPs form conform with sound tax policy are serious questions that we will be considering today and tomorrow.

With respect to the revenue concerns, the staff of the Joint Committee on Taxation has not provided us yet with an estimate of the impact of the master limited partnership activities or on anticipated corporate revenue receipts. We will be very interested in testimony from today's and tomorrow's witnesses which will assist the subcommittee and the staff in determining the revenue impact of this form of business activity. We will look forward to receiving testimony regarding technical and compliance issues relevant to the proper treatment of the master limited partnership. The problems involved in record keeping and the ability to insure proper compliance are of great interest to this committee.

In addition we expect to receive testimony regarding the question of whether certain technical requirements and elections contained in the partnership rules can be properly applied with respect to the master limited partnership.

We look forward to an indepth analysis of these issues today and tomorrow. In order to facilitate our consideration to allow us sufficient time to question witnesses, I would ask that the witnesses, with the exception of the Treasury, to summarize their testimony in a five minute period with the assurances that their entire printed testimony will appear in the record. And I will ask our clerk to make certain that the proper electronic signals are given so that it would advise the witnesses of the remaining time.

I ask that the press release announcing today's hearings be made a part of the record.

Chairman RANGEL. And now it is my distinct pleasure to welcome a fellow New Yorker and a distinguished member of the administration, the Honorable J. Roger Mentz, Assistant Secretary for Tax Policy of the Department of the Treasury.

And before I proceed, I would ask whether or not any member wishes to make an opening statement.

Mr. McGrath?

Mr. McGRATH. Thank you, Mr. Chairman.

I have received an inordinate amount of concern regarding this hearing, and I think as we see the crowd assembled in the hearing room today, we can understand—

Chairman RANGEL. It's not welfare reform.

Mr. McGRATH. This is right—that there are some interesting issues that lie before us here.

I was interested in your comments in your opening statement that the Joint Committee has yet to give us revenue estimates or tell us whether there are any revenue increases in this at all. And if it is your opinion that there may not be any revenues in this, then I suggest we adjourn.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Andrews?

Mr. ANDREWS. Thank you, Mr. Chairman.

I am delighted, Mr. Chairman, that this is not welfare reform we are discussing this morning.

I think it is appropriate that our committee examine this issue very, very carefully. I think it is something that the staff and all of us should look at over the coming months. I think it is important, however, as we examine the witnesses and study the documents that we recognize that the tax reform bill was really enacted only a few short months ago. Many provisions that became effective in January 1987 are still working their way through the marketplace. If we are to examine adequately the impact of the tax bill, I think we need more time to do so.

One of the things I hear from my constituents is to leave the code alone; let the marketplace work its will to see what the long-range and short-range effects and consequences of this tax bill will mean to the marketplace.

As we are aware, master limited partnerships are really a rather new form of pass-through entity. The first MLP was formed in the early 1980's. There are several different kinds of MLPs that we will talk about today: rollouts, rollups, liquidations.

I think it is important that we ask why did these corporations set up MLPs in the first place. Was it for tax avoidance? Or were there other reasons just even more significant?

I know that the energy companies in most of the producing states, for example, use MLPs to raise capital for energy exploration and drilling. Many of them would literally have ground to a standstill without this important vehicle. At a time when the industry is already depressed and imports are on the rise, we need to assess the long-range impact any action we take may have on oil and gas exploration and development.

In addition, the real estate industry has traditionally used the partnership form to raise capital. This industry is also depressed not only in Texas but nationwide as a result of market factors coupled with the retroactive treatment of real estate activities under the passive loss rules.

I recognize that there is concern about the so-called disincorporation of America. And I know Mr. Mentz will address this particular issue.

We should examine also though how all corporations raise investment capital today and whether the investment income is subject to single or double taxation. I urge the committee to examine what is really going on in the marketplace as a result of the 1986 tax changes and caution against any further changes that might add to the crippling of the oil and gas and real estate industries in this country.

Mr. Chairman, I look forward to the hearings this week.

Chairman RANGEL. Are there any further statements?

Mr. GREGG. Mr. Chairman, I would like to echo the concerns raised by my colleagues from Texas and New York. Not coming from either of those States which have a much more intimate involvement with the operative aspects of MLPs, I, however, do have genuine concern. And my concern is that no matter what we do in this area, I don't think we're going to impact only the master limited partnerships. We are going to impact all limited partnerships if we attempt to go down a legislative road.

And as a small town tax practitioner, I always found it exceptionally frustrating that the Treasury Department never did issue regulations or rather only for 48 hours issued regulations on trying to define this area. And it was always very difficult to practice in this area because of the Treasury Department's sort of ax that they held over our heads by not adequately outlining what was and wasn't a partnership.

But if we are going to move into this area, I think we have to acknowledge that we are going to impact all forms of partnerships not just master limited partnerships. The scope of this hearing or any legislation in this area is much broader than just these unique vehicles because any legislation I suspect is not going to be able to be drafted narrowly enough to just impact those vehicles.

Second, I fought very hard in opposition to the repeal of the *General Utilities* doctrine when we were marking up the tax bill in 1986. I think it was a major mistake to repeal that doctrine. I don't think that we should start penalizing corporations which are trying to plan effectively in light of that repeal and trying to do what the *General Utilities* doctrine allowed people to do prior to the 1986 law because I personally feel that that was an appropriate approach anyway. And so, I think one of the things that is causing momentum in this area is an improper consideration, and that's the fact that people are trying to get around the repeal of the *General Utilities* doctrine.

Third, it seems to me that as a very practical matter that anything we do in this area will be arbitrary, that whatever number we pick or whatever way we decide to define what partnerships are, it's going to be an arbitrary decision. And if we're going to make arbitrary decisions legislatively, I think that's a mistake. I would rather have the marketplace drive those decisions than the regulatory effort.

Chairman RANGEL. If there is no—Mr. Dorgan?

Mr. DORGAN. Well, Mr. Chairman, following up on those remarks, I think it is fair to say most of us don't know the difference between an MLP and a four-bottom plow. This is a new area with consequences most of us don't understand or probably recognize. I think that most of us are concerned about what is being proposed and what the impact of it would be. I think it is fair to say I don't have any preconceived notions about what we ought to do, but I am concerned about what is being proposed and what impact it might have on general partnership taxation. I am interested in learning exactly what is happening out in the marketplace and what that might suggest for action or no action on behalf of this committee.

Chairman RANGEL. I recognize the gentleman.

Mr. BROWN. Thank you, Mr. Chairman.

I want to commend the chairman for bringing this matter before us, and following up on it. I think it is a vitally important area, one that deserves and merits our attention. And I want to commend the Treasury for taking a look at this area as well.

This particular discussion with regard to MLPs involves, I think, one of the most remarkable turnarounds in such a brief period of time that I have ever seen in the tax law. Less than a year ago, Treasury's position was that this would not have a significant impact; that is, for the first time in more than a half a century having the corporate rate being higher than the top personal rate would not lead to disincorporation, would not lead to a major loss of revenue in this area. If I understand the Treasury's current position, it is that it could well have a significant impact.

I think it is appropriate to look at this. The relative rates with regard to corporations and individuals I think will result in some changes. I was disappointed that that was not recognized when the tax bill dealt with it. I think it is appropriate to take a look at that area again.

I hope, as we look at it, we will try and make some sense out of the way we treat these trustee entities or nontaxable entities or partnerships, whether we call them MLPs or even look at a subchapter S. To focus only on free transferability I suspect gives us some problems with consistency. We obviously have transferability of ownership in a subchapter S along with the flowthrough concept. Hopefully we will not be about making up a myriad of special entities with special rules, but that the product of our work will be some consistent treatment of these flowthrough entities that makes it not only rational and reasonable for a practitioner to work in this area, but provides some equity in the way we treat individuals who choose to organize and conduct business.

Chairman RANGEL. Mr. Mentz, is it sound tax policy and are we losing money?

**STATEMENT OF HON. J. ROGER MENTZ, ASSISTANT SECRETARY
FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY**

Mr. MENTZ. We are going to lose a lot of money, Mr. Chairman. And I welcome the opportunity to discuss with you and the members of your distinguished committee this issue which seems to have really gotten the public attention. I see there is an article in today's Wall Street Journal about it. So, let me proceed.

At hearings held last June, your subcommittee heard testimony regarding basic policy issues with respect to the taxation of pass-through entities and legislative proposals to amend certain of the tax rules applicable to such entities. One subject addressed at that hearing was the appropriate tax treatment of MLPs. Today's hearing provides us an opportunity to analyze further the MLP form of business organization and particularly to consider how MLPs have been affected by tax reform.

Last June the Treasury addressed the proper income taxation of passthrough entities as part of the broader issue of the income taxation of business enterprises generally. Although our prior testimony endorsed the concept of integrating the corporate and individual

income tax systems, we noted that integration appeared to have been rejected in the political debate then centered around tax reform. And indeed, ultimately integration, even a partial integration, was rejected in last year's tax reform debate.

Based on the assumption of a continued and substantial, separate corporate income tax, our last year's testimony suggested that Congress consider classifying MLPs as corporations for Federal tax purposes. We believed that such classification was justified by considerations of administrative complexity, competitive fairness and ultimate integrity of the corporate income tax base. We think it remains appropriate to consider the proper tax treatment of MLPs in the context of a tax system that permits single level taxation of some business entities but requires double taxation of others, particularly corporations.

The significance of tax reform with respect to the taxation of MLPs extends well beyond the issue of integration, however. The act made fundamental changes in the tax system that significantly affect the taxation of corporate and noncorporate entities and hence the relative attractiveness of the MLP.

At the same time the market for exchange-traded MLPs, which goes back only to 1981, continued to evolve. In particular, the last 12 months have seen rapid growth in the total assets held by MLPs and the diversity of activities carried on in MLP form. Diversity of activities—I want to stress that. We will come back to it later.

The Joint Committee pamphlet out this morning says that in the first five months of 1987 there has been a 245 percent increase in MLP formation, clearly a rather dramatic trend.

Mr. Chairman, I will not cover my full testimony. I ask that it be included in the record. I will just hit a few high points, in particular, our conclusion which restates our suggestion in last year's testimony that Congress consider classifying MLPs as associations taxable as corporations. In offering this suggestion, we recognize the need for appropriate transition relief for existing MLPs and we suggest consideration of a special statutory passthrough vehicle for natural resource development activities. We, like Mr. Andrews, have been concerned and have heard about the problems and difficulties that a change in classification of all MLPs would cause. And quite frankly it is not so much the oil and gas MLPs that are concerning us, but just the complete spectrum of activities that are becoming in an MLP form that is our concern.

My testimony contains a long description of the tax reform implications on MLPs, but in terms of measuring the effect, I think it is perhaps useful to turn to page 7 where we make the observation that although it is difficult to generalize, an appropriate measure of the relative tax advantage of partnerships over corporations before and after tax reform may be obtained by comparing the aftertax rate of return to an investor for the two forms of business organization, assuming an asset mix and financial structure of the enterprise independent of the entity. This is an economist's way of analyzing the relative benefit of partnerships versus corporations.

You'll find the analysis in table 1 at the back of the testimony. And that table shows that for both pre and posttax reform law the percentage increase in aftertax rate of return that may be realized on particular investments if it is held in partnership rather than

corporate form. Now, as that table illustrates, only considering taxes, partnerships are more attractive than corporations for all types of new investment under both pre and posttax reform, and tax reform significantly increases the incentive to conduct business in partnership form.

Overall the act increased the percentage difference from 10.8 percent on the average to 21.7 percent, thereby doubling the investor's incentive to operate in noncorporate form. Why is this? What is the reason for this?

In an oversimplified way, you can look at tax reform as imposing an increased tax on corporations, approximately \$140 billion over a 5-year budget period. Conversely there is about the same amount of tax reduction on the individual side. Now, that institutes a bias in the system in favor of getting income taxed at individual rather than corporate rates. And it is simply that bias that accentuates an existing bias in the system in favor of partnerships that existed under old law. Remember, old law still had the one system of taxation, a passthrough of income, from a partnership to its partners, whereas corporations are subject to their own corporate tax and a separate tax again when profits are distributed as dividends. So, tax reform accentuated the differential that produces an economic advantage to operating in partnership form.

To give you a more concrete indication of this, you can look at the number of subchapter S elections that have been filed in the first 6 months of the year. Going back from 1983 to 1986, they were running around 150,000. This year there are more than 300,000. So, they have more than doubled. This illustrates that there is an advantage to electing out of corporate form and taxpayers are going to do that.

This quantitative analysis doesn't take into account the passive loss rules that were enacted last year. To the extent that income from MLPs is characterized as passive income, then an investor in an MLP will be able to get an advantage if he has losses that are subject to the passive loss rule. That is because any income from the MLP, and the gain recognized from the sale of the interest in the MLP, unless Treasury takes regulatory action to the contrary, will be treated as passive income and will effectively be tax exempt because it will be offset by passive losses.

Income from an investment in a public corporation really is analogous to an MLP, such as an MLP that is traded on the New York Stock Exchange. An investor invests in an MLP for very much the same reasons that he invests in a public corporation. Income from that public corporation would not be passive income and, therefore, would not be available to offset passive losses.

Let me give you a quick description of existing MLPs and future trends, moving to the end of page 9. According to our information there about 126 exchange-traded MLPs in existence or in the process of formation. And as indicated in table 2, it has dramatically increased recently. Three MLPs formed in 1981, 5 in 1982, 6 in 1983, 6 in 1984, 28 in 1985, 38 in 1986, 21 after tax reform was passed.

During 1986 \$3.2 billion was raised in public offerings of MLPs to the public, and \$68.1 billion is the comparable number for all public stock issues.

At least 40 MLPs are in the process of formation right now or have been formed in 1987. Many of these, particularly the more recent ones, are MLPs engaged in a broad spectrum of business activities. And that is our concern, our principal concern. The use of partnerships and joint ventures to conduct oil and gas ventures has certainly been very common, and some MLPs have been developed in that area. But as described in table 2, the MLP has been used for a variety of different businesses. Among the businesses utilizing the MLP form most recently are sports franchises, cable television businesses, gas pipelines, motion picture businesses, hotel and motel chains, health care businesses, restaurant chains and home-building companies.

At the hearing last June there were witnesses who testified in support of continuing the partnership classification of MLPs. They suggested that MLP development would not result in a significant erosion of the corporate tax base because the MLP form is not suitable for active businesses. In fact, one suggested that the MLP sector consists of passive assets that are basically pools of passive investment dollars that pay out a current yield. If that were the case, we would not be so troubled. But as illustrated in table 2, the market has evolved considerably since 1981 and is not limited to MLPs holding passive assets.

From the MLPs that are in existence—and they are detailed in my testimony which I won't discuss orally—several trends can be discerned. First, the MLP is not limited to passive ownership or wasting assets such as oil and gas or natural resource properties. It is increasingly being used for active business enterprises.

Second, it is not limited to businesses that distribute substantially all of their income. Several recent MLPs plan to reinvest most of their earnings and distribute only amounts necessary to pay partner tax liabilities.

And third, MLPs can and are being capitalized in large part by debt. So, the argument that MLPs simply replace corporate debt is fallacious because we are seeing MLPs with significant debt in the structure.

As the marketplace continues to adjust to the operation of businesses in partnership form, we believe that the MLP structure will become more common among existing businesses. Given the substantial incentive to operate in noncorporate form under current law, the use of the partnership form for new business ventures may become the norm rather than the exception.

Let me give you an overview of the policy considerations. You will hear proponents of MLPs explain that use of MLPs is driven largely by nontax considerations. Although MLPs may offer nontax advantages, these advantages are basically attributable to an MLP's tax rather than nontax characteristics. It is the single level of tax, and the benefit in the passive loss rule, that drives MLPs. Putting it another way, we believe that the MLP form would not be used to any significant extent if MLPs were taxed in the same manner as corporations.

You will also hear arguments that MLPs are a form of integration. Corporate shareholder integration is a desirable thing, and we should have more of it in our tax system. The difficulty with this argument is that it is nonuniform. If MLPs retain passthrough

treatment, public corporations that are unable to convert in whole or in part to MLP form will remain subject to double taxation while competitors of similar size and accessing the same capital markets will receive passthrough treatment. Those businesses trapped in corporate form will be disadvantaged in pricing their goods and services and in attracting new equity capital as against MLPs.

We believe such distinctions are inappropriate and that MLPs as an approach to corporate integration raise basic questions of fairness. Mr. Gregg suggested that any line we draw is arbitrary. I would suggest that the line in current law is extremely arbitrary. If a corporation cannot convert to MLP form, it is disadvantaged vis-a-vis another entity that is in partnership form. And that disadvantage should be eliminated or mitigated.

Our prior testimony expressed significant concern over the administrative problems. Those problems still exist.

I think our greatest concern is with regard to the corporate tax base. Fundamentally, we are concerned that expansion in the use of MLPs could erode the corporate tax base. The general rate reductions accomplished in tax reform required a substantial increase in revenues from the corporate sector. Many of the changes in tax reform reflected a public and political judgment that the relative tax burden of corporations should be increased.

If such judgments are to be overturned, it should result from the considered action of the political system rather than private innovation in the uses of passthrough entities. In other words, if you want integration or partial integration, you ought to do it for everyone. You ought not to let only those entities that can get into noncorporate form do so and thereby enjoy an advantage over similarly situated taxpayers that are locked into corporate form.

Attached to my testimony in table 3 are estimates of the revenue consequences of classifying MLPs as corporations. As those estimates indicate, classification of MLPs as corporations would have modest revenue effects over the budget period. But the long-term effect of a change in classification may be different, and we believe vastly different.

The revenue that you would raise from taxing MLPs as corporations is not the same revenue that we will lose if MLPs are allowed to proliferate. That is because without action MLPs will proliferate and gradually, we believe, become the norm for new business. And the corporate level of tax will be significantly eroded.

Nevertheless, Mr. Chairman, I know you are interested in the revenue figures, and table 3 has them. Table 3 shows them in two ways. It shows classifying MLPs only. That's exchange-traded master limited partnerships—taxing them as corporations with and without grandfather provisions, and also all publicly offered limited partnerships.

We are not proposing that just because a partnership is publicly offered that it be taxed as a corporation. That is not our intention or proposal. We show these numbers only to give you an outside boundary of what the maximum revenue would be. And the bottom part of the table would be no change in classification of MLPs as corporations, but treating their income as portfolio income.

Let me just mention that obviously the tables reflect a transition issue. Certainly classifications of MLPs for tax purposes would require development of appropriate transition rules for existing MLPs. And also we believe that consideration should be given to continued authorization of passthrough entities—passthrough treatment of publicly traded entities providing direct investment opportunities in activities traditionally conducted in noncorporate form. Thus, application of a separate corporate tax may be inappropriate where a business entity serves principally to hold relatively passive assets and distribute the income to its owners.

If Congress changes the MLP classification, we think that it should consider extending the current statutory passthrough models, which are basically the REITs, the RICs and more recently the REMICs, to include activities such as natural resource development. We agree with Congressman Andrews that this is a significant concern, and such a separate statutory entity would be appropriate in our view.

In conclusion, Mr. Chairman, our review of the changes in the tax law and the commercial markets over the past year causes us to restate our prior testimony that Congress should consider classifying MLPs as corporations for tax purposes. Although MLPs mitigate the corporate income tax and thus share some of the virtues of formal integration proposals, they provide relief that is both complex administratively and unavailable to many businesses subject to corporate tax. If significant relief from the burden of the separate corporate tax is to be provided, it should be the result of a deliberate process which assures that the relief is provided in a manner that is administrable, fair and fiscally responsible.

We make this suggestion as consistent with our philosophy underlying tax reform in that the expected revenue from the corporate sector would thereby be protected. The proposal is properly viewed as essentially revenue-protecting rather than revenue-enhancing. And that is really the fundamental purpose of this proposal, not to raise the couple of billion dollars that are on table 3, but because we are worried—sincerely worried—that there could be a revenue hemorrhage if MLPs are permitted to proliferate unrestricted and particularly MLPs involving active business that has traditionally been conducted in corporate form.

There would be some logic in Congress delaying full consideration of this issue until the Treasury Department completes its study of subchapter C.

Defining a publicly traded partnership may be difficult. As Mr. Gregg suggested, we would certainly be willing to work with the committee to develop an acceptable definition of those partnerships whose interests may be viewed as publicly traded.

In sum, the Treasury Department believes that consideration raised in our testimony of June 1986 is fundamentally sound. In view of the concerns about possible adverse effects of changes in the classification of MLPs on activities traditionally conducted in partnership form, however, the administration still has this issue under review.

That concludes my prepared remarks, Mr. Chairman. I would be pleased to take questions.

Let me just mention or respond to some of the questions inherent in some of the opening remarks. In Mr. Andrews' opening remarks, I agree with him. We agree. Treasury agrees that a passthrough vehicle would be appropriate for the energy sector. The real estate sector—it is somewhat anomalous that last year we spent a lot of time revising the real estate investment trust rules which are designed specifically for real estate. And yet, today many real estate investments are being structured as MLPs rather than REITs. We don't think that you need another vehicle for real estate because there is already a vehicle and that is REITs.

With respect to Mr. Gregg's remarks, certainly our proposal would not go to all partnerships. It would go only to publicly traded partnerships. We think that is the dividing line. It is easy for exchange-traded partnerships to be included in this characterization. How you define it beyond that where there is a public market but it's over-the-counter or made by an investment banking firm is more difficult. And that is something we would need to work with with you to fine tune. But I don't think—there's no chance that this would encompass all partnerships or, indeed, not even all publicly offered partnerships.

And as I said, I think there is such a degree of arbitrariness in current law that moving in the direction suggested in my testimony would significantly improve fairness. The arbitrariness of making a decision—I don't think it is appropriate to say that let's not decide because to decide would be arbitrary. Not deciding is to continue a more arbitrary and fundamentally unfair system.

I think that in Mr. Brown's question about loss of revenue and why this wasn't picked up in tax reform—we did testify last June. We did not have a good handle on the revenue then, Mr. Brown, and I think that the development of MLPs and the development of our own thinking and analysis contributes to our position right now as being further along than we were. But again to reemphasize, it is not so much the revenue that we would pick up by changing; it's the significant revenue that we would lose by not stopping what is already a proliferation of MLPs.

Okay, Mr. Chairman, now that I've convinced you all of the righteousness of my position, I will entertain questions.

[The prepared statement of Mr. Mentz follows:]

For Release Upon Delivery
 Expected at 9:30 a.m., EDT
 June 30, 1987

STATEMENT OF
 J. ROGER MENTZ
 ASSISTANT SECRETARY (TAX POLICY)
 DEPARTMENT OF THE TREASURY
 BEFORE THE
 SUBCOMMITTEE ON SELECT REVENUE MEASURES
 COMMITTEE ON WAYS AND MEANS
 U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to participate at your request in the Subcommittee's continuing consideration of the taxation of pass-through entities. At hearings on June 9 and 10, 1986, the Subcommittee heard testimony regarding both the basic policy issues with respect to the taxation of pass-through entities and legislative proposals to amend certain of the tax rules applicable to such entities. One subject addressed at the Subcommittee's prior hearings was the appropriate tax treatment of publicly traded limited partnerships, commonly referred to as master limited partnerships ("MLPs").^{1/} Today's hearing provides the opportunity to analyze further the MLP form of business organization, and, in particular, to consider how MLPs have been affected by the Tax Reform Act of 1986 (the "Tax Reform Act" or the "Act") and how the use of such entities has evolved during the past year.

The Treasury Department's testimony last June addressed the proper income taxation of pass-through entities as part of the broader issue of the income taxation of business enterprises generally. In this context, we stated that basic tax policy principles support taxing income from all business activities at equivalent rates, regardless of the form of business entity. Current law departs from those principles in maintaining separate regimes of taxation, resulting in different effective tax rates, for pass-through entities and for businesses operated in corporate form. Although our prior testimony endorsed the concept of integrating the corporate and individual income tax systems in order to achieve greater neutrality in the taxation of business enterprises, we noted that integration appeared to have been rejected in the political debate then centered around tax reform. Based on the assumption of a continued and substantial separate corporate income tax, our testimony suggested that Congress consider classifying MLPs as corporations for federal

^{1/} Unless otherwise noted, the term "master limited partnership" is not intended to refer only to those limited partnerships whose interests are traded on an organized exchange, but rather to the broader class of limited partnerships whose interests are, in fact, publicly traded.

income tax purposes. Such classification was justified in our analysis by considerations of administrative complexity, competitive fairness, and the ultimate integrity of the corporate income tax base.

The tentative judgment offered in our earlier testimony regarding the near-term prospects for significant integration of the corporate and individual income tax systems has been confirmed by subsequent events. The Tax Reform Act did not adopt any of the integration provisions contained in earlier tax reform proposals, and in important respects actually reinforced the effect of the separate corporate income tax. It thus remains appropriate to consider the proper tax treatment of MLPs in the context of an income tax system that permits single level taxation for some business entities but requires double level taxation for others.

The significance of the Tax Reform Act with respect to the proper taxation of MLPs extends well beyond the issue of corporate integration. The Act made fundamental changes in the tax system that significantly affect the taxation of corporate and noncorporate entities and hence the relative attractiveness of the MLP form of organization. At the same time, the market for exchange-traded MLPs, which dates back only to 1981, has continued to evolve. In particular, the last twelve months have seen rapid growth in the total assets held by MLPs and the diversity of activities carried on in MLP form.

My testimony today will examine the proper tax treatment of MLPs in light of the changes in the tax law and commercial markets since the Subcommittee's last hearings. I will first analyze the changes made by the Tax Reform Act and the effect of these changes on the business decision whether to operate in corporate or noncorporate form. I will next review existing uses of the MLP form, with an emphasis on possible emerging trends. Finally, I will discuss our views regarding the appropriate tax treatment of MLPs in light of their current and possible future characteristics. In general, our conclusion restates the suggestion in our prior testimony that Congress may wish to consider classifying MLPs as associations taxable as corporations. In offering this suggestion, we recognize the need for appropriate transition relief for existing MLPs and suggest consideration of a special statutory pass-through vehicle for natural resource development activities.

I. Tax Reform Act Changes Affecting MLPs

A. Description of Changes

Basic Rules. Although the income or loss of a partnership is calculated at the entity level, no entity level tax is imposed. Instead, the items of partnership income, gain, loss, deduction, and credit are passed through to the partners, retaining their character in the hands of the partners.^{2/} Partnership income is

^{2/} The activities of a partnership are, in effect, imputed to the partners, with all partnership items treated as incurred directly by the partners. For example, if the partnership engages in an active trade or business, the distributive share of the income of a tax-exempt partner generally is treated as unrelated business taxable income. Similarly, if the partnership conducts a trade or business in the United States, the distributive share of income of a nonresident alien partner is treated as income effectively connected with a trade or business conducted in the United States.

taxed to the partners whether or not the partnership distributes the income and partnership losses can be deducted by the partners, subject to certain limitations.

In contrast to the pass-through taxation of partnerships, the income of corporations generally is subject to two levels of taxation.^{3/} The corporation is taxed as a separate entity when the income is earned and its shareholders are subject to an additional tax when they receive distributions of income or sell or exchange their shares at a gain. In general, the losses of a corporation can be utilized only to offset the past or future income of the corporation.^{4/}

The Tax Reform Act did not significantly alter the basic rules under which the income of partnerships and corporations is subject to tax. As indicated above, the issue of corporate integration was raised during the tax reform process and various proposals to provide partial relief from the separate corporate income tax were directly considered by Congress.^{5/} Ultimately, however, these proposals were not adopted, leaving intact the classical two-level tax system for corporate income.

Tax Rates. Prior to the Tax Reform Act, the maximum statutory tax rate on individual income, including an individual's share of partnership income, was 50 percent (20 percent for long-term capital gains), while the maximum statutory corporate income tax rate was 46 percent (28 percent for long-term capital gains). Taking account of shareholder level taxes, the maximum combined rate of tax on currently distributed corporate income was 73 percent.^{6/}

The dramatic lowering of maximum tax rates by the Tax Reform Act, to 28 percent for individuals and 34 percent for corporations, has resulted in a maximum corporate rate that exceeds the maximum individual rate for the first time since

^{3/} Certain corporations are afforded relief from the so-called "classical" two-level tax structure through the allowance of a dividends paid deduction or other form of integration of the corporate and individual tax systems (e.g., real estate investment trusts ("REITs"), regulated investment companies ("RICs"), real estate mortgage investment conduits ("REMICs"), and S corporations).

^{4/} To the extent the corporation's losses are reflected in the value of its stock, and result in the realization of a loss upon the sale of the shares, the shareholder's loss can be used to offset other capital gains.

^{5/} Proposals to integrate partially the corporate and individual income tax systems through the allowance of a dividends paid deduction were included in the Treasury Department's November 1984 report to the President on tax reform (which proposed a 50 percent dividends paid deduction, to be phased in over a six year period), the President's May 1985 tax reform proposals to the Congress (which proposed a ten percent dividends paid deduction, effective immediately), and the tax reform bill originally passed by the House of Representatives (which contained a ten percent dividends paid deduction, to be phased in over a ten year period).

^{6/} The combined tax rate of 73 percent is equal to the sum of: (a) the 46 percent corporate tax rate and (b) the 50 percent individual tax rate times the 54 percent of corporate income available for distribution after payment of the corporate tax.

1913. Under the Act, the maximum combined tax rate on currently distributed corporate income will be 52.48 percent.^{7/} The Act also repealed the preferential tax rate on capital gains, so that individual and corporate capital gains will be subject to tax at maximum rates of 28 and 34 percent, respectively.

Taxation of Contributions, Distributions, and Major Capital Transactions. The Tax Reform Act did not alter the basic rule that contributions or distributions of assets to or from a partnership are generally nontaxable events. Consequently, the formation or in-kind liquidation of a partnership generally remains nontaxable.

Contributions to and acquisitions by corporations are nontaxable events only if certain conditions are satisfied.^{8/} Corporate distributions generally are taxable to the shareholders as ordinary income to the extent of the earnings and profits of the corporation. Distributions in redemption of a shareholder's stock may be taxable as ordinary distributions or as proceeds from a sale of the stock, depending on the effect of the transaction on the shareholder's ownership interest in the corporation.

In general, corporations are subject to tax on the sale or distribution of appreciated property. Prior to the Tax Reform Act, this rule was subject to exceptions that significantly limited its effect. In particular, under the so-called General Utilities doctrine, sales or distributions as part of the complete liquidation of a corporation generally were exempt from corporate level tax. The Tax Reform Act eliminated the General Utilities doctrine so that appreciation on corporate assets, as with other corporate income, is now subject to double level tax.^{9/}

Partnership Losses. The Tax Reform Act added rules restricting the current deduction of losses from passive activities, generally including a limited partner's share of partnership losses. In particular, prior to the disposition of a passive activity, losses from the activity may not be used to offset income from nonpassive activities, including salary income and portfolio income, such as interest, dividends, or royalties. Losses from a passive activity remain currently deductible, however, against income from passive activities, generally

7/ The combined tax rate of 52.48 percent is equal to the sum of: (a) the 34 percent corporate tax rate and (b) the 28 percent individual tax rate times the 66 percent of corporate income available for distribution after payment of the corporate tax.

8/ Generally, gain or loss is recognized to a shareholder on the contribution of property to a corporation in exchange for stock or securities of the corporation unless such shareholder and any other contributors control the corporation immediately after the exchange. In addition, other acquisitions may be taxable events unless the detailed requirements of the corporate reorganization provisions are satisfied.

9/ Corporate level nonrecognition on liquidating distributions is preserved for liquidations of certain controlled subsidiaries. Since the parent corporation also inherits the subsidiary's tax basis in its assets, appreciation in the assets is preserved for future corporate level tax upon a sale or distribution by the parent.

including a limited partner's share of partnership income.^{10/}

B. Effects of the Changes Made by the Tax Reform Act

Changes in Tax Rates and Base. As described above, the Tax Reform Act dramatically lowered the maximum statutory rates of tax applicable to corporate and partnership income. The effect of these rate reductions is difficult to determine, however, since the effective, rather than the statutory, tax rate on a partnership's or corporation's income varies with its particular activities. Thus, tax incentives in the form of credits or cost recovery deductions have substantially offset statutory tax rates on the income from certain assets. Moreover, a number of factors have tended to protect corporate income from full double taxation, including: (i) issuance of debt, which generates deductible interest; (ii) retention rather than current distribution of corporate earnings, which may defer, eliminate, or, prior to the Tax Reform Act, result in a preferential capital gain rate for the shareholder level tax; and (iii) liquidating distribution or sale of appreciated assets, which, prior to the Tax Reform Act, exempted the appreciation from corporate level tax.

Since business entities differ widely in the nature of their activities, their level of debt capitalization, the extent to which they distribute or retain earnings, and in the degree to which they hold appreciated assets, the effect of tax reform on the relative attractiveness of the partnership form is not uniform. Although it is therefore difficult to make general observations, we think an appropriate measure of the relative tax advantage of partnerships over corporations before and after tax reform may be obtained by comparing the after-tax rate of return to an investor for the two forms of business organization, assuming that the asset mix and financial structure of the enterprise is independent of the nature of the entity.

Table 1 shows (for both pre- and post-Tax Reform Act law) the percentage increase in the after-tax rate of return that may be realized on the listed investment if such investment is made in partnership rather than corporate form. In addition, the table lists the overall percentage increase in after-tax return for the typical mix of corporate investment. As the table illustrates, when only taxes are considered, partnerships are more attractive than corporations for all types of new investment under both pre- and post-Tax Reform Act law. Moreover, the table shows that the Tax Reform Act significantly increased the incentive to conduct business in partnership form. Overall, under prior law, partnership investment would have yielded the investor an after-tax rate of return 10.8 percent higher than earned on the same mix of investments undertaken in corporate form. The Act increased this percentage difference to 21.7 percent, thereby doubling the investor's incentive to operate in noncorporate form.

A more concrete indication of the effect of the Tax Reform Act on the incentives to operate in corporate or pass-through form is given by the number of corporations that have elected to be taxed under the pass-through rules of subchapter S. Between January 1 and June 30 (the heaviest filing period for S

^{10/} The general rule that income from a limited partnership is passive income is subject to exceptions. For example, a partnership's portfolio income retains such character in the hands of the partners. In addition, under section 469(k)(3), the Treasury Department has regulatory authority to provide that income from certain passive activities is not treated as passive income.

elections), S elections numbered approximately 147,000 in 1983, 187,000 in 1984, 133,000 in 1985, and 174,000 in 1986. By contrast, 329,000 S elections were filed between January 1 and May 30, 1987.

Other Considerations. The analysis above of relative incentives for operating in partnership or corporate form does not take account of the new passive loss rules adopted in the Tax Reform Act. To the extent that the income from MLPs is characterized as passive income under these rules, an investor in an MLP would be able to offset his share of partnership operating income and any gain recognized on the sale of the partnership interest against passive losses that otherwise might not be currently deductible. Since income from an investment in a public corporation would generally not be passive income, characterization of MLP income as passive could significantly increase the relative attractiveness of MLPs over corporations. On the other hand, to the extent that MLPs generate losses, the addition of the passive loss rules limiting current use of those losses reduces the attractiveness of MLPs.

In addition, our analysis of relative incentives does not reflect the impact of the corporate alternative minimum tax adopted in the Tax Reform Act. The provisions of the corporate minimum tax, in particular, the book income preference, would further increase the incentives favoring the partnership form of organization.

II. Existing MLPs and Future Trends

A. Background

Existing MLPs generally fall into one of four categories, based on their method of formation: (i) "roll-up MLPs," formed by the combination of two or more partnerships into one publicly traded partnership; (ii) "liquidation MLPs," formed by a complete liquidation of a corporation into an MLP; (iii) "acquisition MLPs," formed by an offering of MLP interests to the public, with the proceeds used to purchase assets; or (iv) "roll-out MLPs," formed by a corporation's contribution of operating assets in exchange for general and limited partnership interests in the MLP, followed by a public offering of limited partnership interests by the corporation or the MLP, or both. A fifth category of MLP, that may well predominate in the future, is the "start-up MLP," formed by a partnership that is initially privately held but later offers its interests to the public in order to finance internal growth.

All MLPs employ accounting conventions to simplify application of the partnership tax rules and maintain the interchangeability of the limited partnership interests.^{11/}

^{11/} To facilitate the trading of interests in an MLP, the limited partnership interests are typically deposited with a bank, or other depository, and depository receipts are issued in registered form representing such interests. The depository receipts are listed and traded, usually on one of the major exchanges instead of the over-the-counter market to avoid the necessity of complying with state blue sky laws. Assignees of these depository receipts are treated as limited partners for federal income tax purposes regardless of whether an assignee is formally substituted as a limited partner. Further, to limit the administrative burden of trading, MLPs permit purchasers of interests to hold such interests in nominee accounts provided that the nominee files an application to become a substitute limited partner. As a result, many investors hold their interests in a "street name."

Certain of these conventions, although not adopted for a tax avoidance purpose, are inconsistent with the statute and/or regulations. First, MLPs have adopted their own methods (inconsistent with the applicable regulations under section 755) of allocating adjustments to the basis of MLP assets. Moreover, to the extent that the basis of depreciable assets is adjusted, MLPs treat the adjustment as recoverable under the rules applicable when the asset was placed in service by the partnership rather than when the adjustment is made. In addition, where an MLP is formed through the contribution of several partners, as in a roll-up MLP, MLPs typically assume, for purposes of section 704(c), that the gain or loss inherent in each contributed asset is allocated in accordance with each partner's interest in the partnership. Finally, MLPs use "curative allocations" of income or loss to offset the differences in tax characteristics among partnership interests that result from the application of sections 704(b) and 704(c).

MLPs have adopted other "simplifying assumptions" regarding the application of the substantive rules of subchapter K. Among these assumptions are monthly or bimonthly conventions regarding the identification of the partners and conventions regarding the sales price of traded units. The monthly convention, for example, typically assumes that the partners owning units on the last day of the month have owned the units for the entire month. Further, it appears that in certain circumstances, MLPs are making adjustments in the basis of their assets under section 743(b) and section 754 that may be inappropriate.^{12/}

B. Existing MLPs

According to our information, at present there are approximately 126 exchange-traded MLPs in existence or in the process of formation. Table 2 shows the number of exchange-traded MLPs by type of formation, year of formation, and nature of activity. As shown in Table 2, 3 MLPs were formed in 1981, 5 in 1982, 6 in 1983, 6 in 1984, 28 in 1985, and 38 in 1986 (21 formed after September 1986).^{13/} A summary of financial statistics from the 1985 tax returns of certain exchange-traded MLPs is attached as Appendix A. During 1986, \$3.2 billion in MLP interests were offered to the public, compared to \$61.8 billion in new stock issues by corporations in the same year.^{14/} At least 40 MLPs are currently in the formation process or have been formed in 1987. As Table 2 indicates, more than two-thirds of the existing or pending MLPs are engaged in the oil and gas or

^{12/} Certain MLPs, relying on analogous authority under section 351, have increased the basis of partnership assets for the premium paid to an underwriter for the units in a firm commitment underwriting. Section 709 prohibits a partnership from deducting or amortizing syndication fees.

^{13/} The transition rules for the repeal of the General Utilities doctrine permitted corporations that completely liquidated before January 1, 1987 to avoid full recognition of corporate level gain as under prior law. This provision provided a significant incentive for the formation of liquidation MLPs prior to January 1, 1987.

^{14/} For the same period, there were \$134.1 billion in corporate stock repurchases and \$46.2 billion in corporate retained earnings.

real estate business.^{15/} As illustrated in Table 2, however, many of the more recently formed or proposed MLPs are engaged in a much broader spectrum of business activities. For example, of the 61 MLPs formed or in the process of formation since the passage of the Tax Reform Act, only 22 are in the oil and gas or real estate business while 39 are in other industries.

As noted in Table 2, excluding some of the transactions that are in registration, there are 20 roll-up MLPs, 23 liquidation MLPs, 29 roll-out MLPs, and 45 acquisition MLPs. Virtually all of the roll-ups and many of the roll-outs occurred in the oil and gas industry, whereas acquisitions and to a lesser extent liquidations have been used more frequently in real estate and other industries.

The use of partnerships and joint ventures to conduct oil and gas ventures has been very common, and thus some of the growth in the number of MLPs in this industry may continue to arise through the formation of roll-up MLPs. Most oil and gas and timber MLPs created by the transfer of assets out of corporate solution have involved only the interests in the natural resource properties of such corporations, and not their "downstream" operations such as milling, processing, refining, or marketing activities.

As described in Table 2, however, the MLP form has been used for a variety of different businesses. Among the businesses utilizing the MLP form most recently are sports franchises, cable television businesses, gas pipelines, motion picture businesses, hotel and motel chains, health care businesses, restaurant chains, and home building companies. At the hearing last June, several witnesses testifying in support of the continued classification of MLPs as partnerships suggested that the development of MLPs would not result in a significant erosion of the corporate tax base because the MLP form is not suitable for active businesses. Others suggested that the MLP sector "consist[s] of passive assets that are basically pools of passive investment dollars that pay out a current yield."^{16/} As illustrated by the above figures, however, the market has evolved considerably since 1981, and is no longer limited to MLPs holding passive assets. Indeed, several of the more recent actual and proposed transactions illustrate the significant flexibility of the MLP form.

^{15/} The statutory rules applicable to REITs provide a special pass-through regime for real estate investment. Unlike MLPs, REITs are subject to restrictions limiting them to passive investment activities, must currently distribute substantially all of their income, and cannot pass through losses to investors. Many real estate MLPs engage in development and management activities barred to REITs. In amending the REIT rules in the Tax Reform Act, Congress carefully considered the issue of what activities REITs should be permitted to engage in without becoming subject to corporate level tax. To the extent the Tax Reform Act provisions identified Congress' intended scope of pass-through treatment for publicly held real estate entities, the existence of real estate MLPs whose activities are unrestricted is anomalous.

^{16/} Statement of William S. McKee, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Hearing on Issues Relating to Pass-Through Entities, June 9, 1986. See also, statements of Barksdale Hortenstine and Mark A. Kuller.

In early 1987, a Professional sports team, operating in corporate form, filed a preliminary prospectus offering to the public over \$20,000,000 of MLP interests.^{17/} The MLP would succeed to the assets and liabilities of the corporation, which would be the general partner and would also hold approximately 60 percent of the limited partnership interests. The proceeds of the public offering would be used to retire indebtedness incurred by the corporation in connection with the prior acquisition of the business and to fund certain construction costs and the working capital needs of the MLP. The business of the MLP would be to own and operate a professional sports franchise and to promote a municipally-owned multi-purpose sports and entertainment facility. The franchise operations include the sale of tickets and the licensing of television, cable television, and radio broadcast rights. The MLP would also share in the arena's food, beverage, merchandise, and parking revenues.

A recent MLP formed by the liquidation of a corporation is engaged in the home building business. This MLP has itself acquired a substantially larger home building corporation in a two-stage leveraged buy-out. The first stage consisted of the MLP's formation of two acquisition corporations that each made cash tender offers for a portion of the target corporation's shares. The funding for the tender offers was provided almost exclusively by bank loans and the issuance of debt securities. Following the acquisition of sufficient shares to control the target, the MLP caused the acquisition corporations jointly to form a subsidiary which was merged into the target corporation. In the merger, the remaining target shareholders received cash and MLP interests.

In addition to the participation of MLPs in leveraged buy-outs, MLPs also have been used following such acquisitions. For example, in February 1987, the business of a corporation that had been acquired in a leveraged buy-out was converted to partnership form. This was accomplished by having the acquired corporation contribute its business (the wholesale distribution of industrial products) to a partnership in exchange for a \$100 million note and \$100 million of partnership interests. These partnership interests were then sold by the corporation to the public and the MLP issued \$110 million in notes to the public, using the funds to retire its debt to the sponsor. Presumably, the sponsor used the proceeds of the sale of the partnership interests and the repayment of its loan to the partnership to retire its acquisition indebtedness. The prospectus for this MLP represents that cash distributions on the partnership interests (other than a class of partnership interests analogous to preferred stock) will be approximately equal to the tax liability of the partners with respect to the MLP's taxable income from the previous year.^{18/}

MLPs have been organized to conduct a variety of other businesses. For example, in December 1986, a corporation operating over 50 long-term health care centers (over 6,500 beds) and over 20 home health care programs, liquidated into an MLP.

The MLP has approximately 6,000 employees. The prospectus states that the MLP's cash distribution policy following this conversion will be to distribute annually to the partners an

^{17/} This transaction involves the second conversion of a professional sports franchise to MLP form.

^{18/} The same policy with respect to distributions was announced by an MLP created in January of this year to engage in the motion picture business.

amount equal to the tax savings from doing business in partnership form.

Another MLP was formed earlier this year by the roll-out of the liquefied petroleum gas processing, transportation, storage, and distribution business of the corporate sponsor. The MLP has approximately 3,500 employees. The sponsor retained approximately 40 percent of the interests in the partnership. As part of the formation, the MLP assumed approximately \$130 million in debt, representing about 25 percent of the value of the business. The MLP intends to distribute all of its net cash flow and to finance acquisitions through borrowings and the sale of additional interests in the partnership. Another similar transaction, considered in March 1987, would involve the purchase of a natural gas pipeline by an MLP from the corporate sponsor. Thirty percent of the purchase price paid by the MLP would be funded by the offering of MLP interests and 70 percent would be funded by the offering of debt.

Several trends can be discerned from the recent actual and proposed transactions involving MLPs. First, the MLP form is not limited to the passive ownership of wasting assets, such as oil and gas and other natural resources, but is increasingly used by active business enterprises. Second, the MLP form is not limited to businesses that distribute substantially all of their income. Several recent MLPs plan to reinvest most of their earnings and distribute only those amounts necessary to pay partner tax liabilities. Third, MLPs can be capitalized in large part by debt. It has been suggested that the inability of tax-exempt investors to acquire MLP equity without generating unrelated business income will deny MLPs a large source of capital, thereby limiting their growth. Tax-exempt investors can, however, invest in MLP debt without generating unrelated business income.

As the marketplace continues to adjust to the operation of businesses in partnership form, we believe the MLP structure will become more common among existing businesses. More importantly, given the substantial incentive to operate in noncorporate form under current law, the use of the partnership form for new business ventures may become the norm rather than the exception. Whether these new businesses are formed initially as MLPs or instead as smaller partnerships that later become MLPs, the number of new businesses in MLP form may be expected to increase rapidly.

III. Policy Considerations

A. Advantages of the MLP Form

Proponents of MLPs often explain that the use of MLPs is driven largely by nontax considerations. For example, it has been stated that the use of the partnership form permits the raising of capital without incurring debt, permits a corporation to highlight the value of assets that otherwise would be undervalued by the market, and encourages more efficient management and investment practices by encouraging the distribution rather than retention of earnings. Without questioning that MLPs may offer the above advantages, it is important to recognize that such advantages are, in fact, grounded in the differences in tax treatment between partnerships and corporations. Use of the MLP form may substitute for the issuance of additional corporate debt, but only because the partnership form offers the same tax advantage -- avoidance of entity level tax -- as corporate debt. An MLP may enable a

corporation to highlight undervalued assets, but the same purpose would be equally served by a corporate subsidiary save for the difference in tax treatment. MLPs are more likely than corporations to distribute earnings currently, but only because corporate distributions trigger a second level of tax. Thus, although MLPs may offer nontax advantages, these advantages are attributable to an MLP's tax rather than nontax characteristics. To put the point in other terms, we believe it evident that the MLP form would not be used to any significant extent if MLPs were taxed in the same manner as corporations.

B. Ad Hoc Integration

What the stated nontax advantages of MLPs do illustrate is that partnership classification for MLPs offers certain of the advantages associated with direct proposals to eliminate, or at least reduce, the corporate income tax. Thus, the inefficiencies attributable to the separate corporate tax, such as the incentives it creates for excessive debt capitalization or retention of earnings, will be relieved to a greater or lesser extent by any proposal that effectively reduces the burden of that tax. Formal proposals for integration of the corporate and individual income taxes have attempted to provide that relief in a systematic manner that extends across the corporate sector. In contrast, the use of MLPs is limited by a variety of circumstances unrelated to the burden of the corporate tax. Although start-up businesses may have broad access to MLPs,^{19/} their use by an existing corporation generally requires a transfer of assets to an MLP. A corporation's ability to transfer assets will depend on such factors as the tax and nontax cost of the transaction, as well as the severability of the transferred assets from the rest of the corporation's activities. Finally, the substantial costs of forming and operating an MLP and the variations in such costs among different industries may make it more burdensome for certain publicly traded entities, particularly those that are relatively small, to take advantage of the MLP form.

If MLPs retain pass-through treatment, public corporations unable to convert in whole or in part to MLP form will remain subject to double taxation, while competitors of similar size and accessing the same capital markets will receive pass-through treatment. Those businesses trapped in corporate form will be disadvantaged in pricing their goods and services and in attracting new equity capital as against MLP competitors. We believe such distinctions to be inappropriate and that MLPs, as an approach to corporate integration, raise basic questions of fairness.

C. Administrative Considerations

Our prior testimony expressed significant concern over the administrative problems presented by MLPs. Utilization of the partnership model of taxation for business entities, the

^{19/} The use of MLPs by start-up businesses may currently be limited by market perceptions of MLPs as high-yield investments. Such perceptions, however, are likely to be transitory. As described above, MLPs have increasingly been formed to carry on active businesses, with an announced policy to distribute earnings only as necessary to satisfy the partners' tax liabilities.

interests in which are widely held and frequently transferred, creates difficult accounting and tax collection issues, with attendant compliance and enforcement problems for the Internal Revenue Service ("IRS") and the entities themselves. It is principally for this reason that partnership model integration of the corporate and individual taxes has been rejected, both by those countries providing integrated corporate tax systems, and by the United States in providing integrated systems for special purpose entities such as RICs and REITs.

As described earlier in this testimony, existing MLPs employ a number of simplifying assumptions in order to account for the entity's operations under the rules of subchapter K. Although such assumptions may make the tax accounting problems of MLPs relatively manageable, we are concerned that they result in possibly significant inaccuracies. Moreover, we are concerned about whether the IRS can verify their accuracy through the audit process, and enforce liabilities where inaccuracies are discovered.

One of the historical justifications for a separate corporate level tax is the difficulty in accounting for a widely held business's activities under a pure pass-through model. The administrative difficulties of a pass-through model for MLPs, however, could be addressed by measures short of taxing MLPs as corporations. For example, the constructive termination rules of section 708(b) could be revised or eliminated with respect to MLPs. Methods currently used by MLPs to approximate income allocations and basis adjustments could be expressly sanctioned. More significantly, enforcement and collection difficulties could be minimized by imposing a withholding tax on MLPs and collecting any tax deficiencies from the MLP (thereby forcing the current partners, rather than the partners in the year to which the deficiency relates, to bear the burden of the additional tax).

Adoption of the above measures would substantially reduce the administrative difficulties in taxing MLPs. The need for such measures, however, is a substantial indication that MLPs do not possess requisite partnership characteristics. Ultimately, the significance of the administrative problems of MLPs is not that the problems are insoluble, but that their solution requires movement away from the traditional partnership model and in the direction of a new, hybrid pass-through entity, possessing additional corporate characteristics.

There is no precedent for a special statutory pass-through entity unrestricted in its size or activities. Moreover, the arguments that might support creation of such an entity do not differ in kind from the arguments that generally support integration of the corporate and individual income tax systems.

D. The Corporate Tax Base

Our review of the existing market for MLPs indicates that an increasingly diverse array of business activities are conducted in MLP form. Although the total capital investment in MLPs remains relatively small, the growth in MLP utilization has been rapid. If MLPs retain pass-through treatment, we expect rapid growth to continue. We recognize that the tax incentives for large, publicly held businesses to operate in MLP form may be offset by tax and other costs involved in forming and operating an MLP. Increasingly, however, the tax law will cause businesses entering the public capital markets to utilize the MLP rather than corporate form.

As I have previously stated, MLPs achieve a form of integration and, in this respect, serve certain of the tax policy principles that generally support integration of the corporate and individual income tax systems. Significant movement toward integration, however, should be based on deliberate policy choices rather than self-help actions that strain the boundaries of existing pass-through vehicles. In part, this reflects the administrative and fairness concerns discussed earlier in this testimony. More fundamentally, however, we are concerned that expansion in the use of MLPs could erode the corporate tax base. The general rate reductions accomplished in tax reform required a substantial increase in revenues from the corporate sector. Moreover, although the legislative record need not be read to indicate a rejection of corporate integration in principle, many of the changes in the Tax Reform Act reflected a public and political judgment that the relative tax burden on corporations should be increased. If such judgments are to be overturned, it should result from the considered action of the political system rather than private innovation in the uses of pass-through entities.

Attached to my testimony are estimates of the revenue consequences of classifying MLPs as corporations for tax purposes. As the estimates indicate, classification of MLPs as corporations would have only modest revenue effects over the budget period. The long-term effect of a change in classification may be different, however, as suggested by the steadily increasing revenue effects over the budget period.

E. Transition Issues

A change in the classification of MLPs for tax purposes would require development of appropriate transition rules for existing MLPs. These rules could take a number of forms, such as "grandfathering" of partnership status for a fixed time period. In any event, we believe it important that existing MLPs formed in reliance on the provisions of current law be provided adequate time to adjust or resolve their activities before being subjected to the corporate income tax.

F. Possible Statutory Exceptions

In conjunction with any change in the classification of MLPs for tax purposes, we believe consideration should be given to continued authorization of pass-through treatment of publicly traded entities providing direct investment opportunities in activities traditionally conducted in noncorporate form. Thus, application of a separate corporate tax may be inappropriate where a business entity serves principally to hold relatively passive assets and distribute the income to its owners.

Under current law, a similar rationale has supported pass-through treatment for publicly traded entities organized as REITs, RICs, and, more recently, REMICs. Although these statutory pass-through vehicles provide investors with liquidity and diversification, they effectively preserve the regime of taxation traditionally faced by investors in real estate, corporate securities, and real estate mortgages.

If Congress changes the classification of MLPs for tax purposes, we suggest that it consider extending the current statutory pass-through models to include activities such as natural resource development. Thus, as with REITs, RICs, and REMICs, entities engaged principally in developing timber, coal, oil and gas, and other natural resources serve a relatively

passive function, generating income from wasting assets and distributing it to investors. Given the importance of natural resource development to the nation's security, Congress should consider carefully whether such traditionally noncorporate activities should be subjected to corporate level tax.

IV. Conclusion

In conclusion, our review of the changes in the tax law and commercial markets over the past year causes us to restate the suggestion in our prior testimony that Congress consider classifying MLPs as corporations for tax purposes. We make this suggestion without qualifying our historical support for the concept of integrating the corporate and individual income tax systems. In our judgment, however, although MLPs mitigate the corporate income tax, and thus share some of the virtues of formal integration proposals, they provide relief that is both complex administratively and unavailable to many businesses subject to the corporate tax. If significant relief from the burden of the separate corporate income tax is to be provided, it should be the result of a deliberate process, which assures that the relief is provided in a manner that is administrable, fair, and fiscally responsible.

We regard this suggestion as consistent with the philosophy underlying tax reform in that the expected revenue from the corporate sector would thereby be protected. Thus, the proposal is properly viewed as essentially revenue-protecting rather than revenue-enhancing and would not reopen issues resolved in tax reform.

There would be some logic in Congress delaying full consideration of this issue until the Treasury Department completes its study of Subchapter C of the Code. The Tax Reform Act required the Treasury Department to submit this study to Congress by January 1, 1988. We expect that the study will consider a wide range of corporate issues, which may establish a broader framework for considering the tax treatment of MLPs.

Defining a publicly traded partnership may be difficult. Interests in many partnerships that are not traded on organized exchanges can be sold through a number of firms, although the market for any individual partnership interest may be rather thin. In addition, major investment brokerage houses typically undertake to make a market in their partnership offerings, either in their role as broker or as a general partner. As a result, restricting the definition of publicly traded partnerships only to those whose interests are traded on an organized exchange may be too narrow. On the other hand, treating publicly offered, but not publicly traded, limited partnerships as corporations would seem inappropriate, since these entities do not presently raise the same level of concern. If the Subcommittee decides to undertake an effort to revise the classification rules, we are of course willing to work with it and the Congress to develop an acceptable definition of those partnerships whose interests may be viewed as publicly traded.

In sum, the Treasury Department believes that the considerations raised in our testimony of June 1986 remain basically sound. In view of concerns about possible adverse effects of changes in the classification of MLPs on activities traditionally conducted in partnership form, however, the Administration still has the issue under review.

This concludes my prepared remarks. I would be pleased to answer any questions.

Table 1

Percentage Increase in the After-Tax
Rate of Return to an Investor Conducting
Business in Partnership Rather Than Corporate Form ^{1/}

Asset	Relative After-Tax Return ^{2/}	
	Prior Law	TRA
Equipment	6.9	18.7
Structures	10.0	22.6
Inventory	15.6	23.7
Land	15.6	23.7
Overall	10.8	21.7

Department of the Treasury
Office of Tax Analysis

June 29, 1987

^{1/} Calculations assume a real 8 percent pre-tax return on all investments, a 4 percent inflation rate, and include the effects of cost recovery allowances and statutory income tax rates at the Federal and state levels. Financing is two-thirds equity and one-third debt. Most of the return to corporate equity (93 percent) is taxed as a capital gain, with the remainder (7 percent) of the return to corporate equity taxed as a dividend.

^{2/} Difference between the noncorporate after-tax return and the corporate after-tax return, expressed as a percentage of the corporate after-tax return.

Table 2

Number of Exchange Traded MLPs by Year of Formation,
Method of Formation, and Nature of Activity

Year/Nature	Roll-Up	Liquidation	Roll-Out	Acquisition	Unknown	Total
1981						
Oil and Gas		1	1			2
Real Estate		$\frac{1}{2}$	$\frac{1}{1}$			$\frac{1}{3}$
Subtotal		$\frac{1}{2}$	$\frac{1}{1}$			$\frac{1}{3}$
1982						
Oil and Gas	3		1			4
Timber		$\frac{1}{1}$	$\frac{1}{1}$			$\frac{1}{3}$
Subtotal	$\frac{3}{3}$	$\frac{1}{1}$	$\frac{1}{1}$			$\frac{1}{3}$
1983						
Oil and Gas	1	1	1			3
Real Estate		$\frac{1}{2}$	$\frac{1}{1}$	$\frac{2}{2}$		$\frac{3}{6}$
Subtotal	$\frac{1}{1}$	$\frac{1}{2}$	$\frac{1}{1}$	$\frac{2}{2}$		$\frac{3}{6}$
1984						
Oil and Gas	3		1			4
Real Estate	$\frac{1}{4}$		$\frac{1}{1}$	$\frac{1}{1}$		$\frac{2}{6}$
Subtotal	$\frac{3}{4}$		$\frac{1}{1}$	$\frac{1}{1}$		$\frac{2}{6}$
1985						
Oil and Gas	9	2	7			18
Timber	1	3				4
Real Estate		$\frac{2}{7}$	$\frac{4}{4}$	$\frac{4}{4}$		$\frac{6}{28}$
Subtotal	$\frac{10}{10}$	$\frac{2}{7}$	$\frac{7}{7}$	$\frac{4}{4}$		$\frac{28}{28}$
1986						
Oil and Gas	2		2			4
Real Estate		5	2	8		15
Motels/Restaurants		2	1	4		7
Cable TV			1	1		2
Other		4		6		10
Subtotal	$\frac{2}{2}$	$\frac{11}{11}$	$\frac{6}{6}$	$\frac{19}{19}$		$\frac{38}{38}$
1987 (through 6/29/87)						
Oil and Gas			1	2		3
Real Estate	1	2	2	4	4	13
Motels/Restaurants			1	4	1	6
Cable TV				2	2	4
Other		$\frac{1}{3}$	$\frac{5}{9}$	$\frac{6}{18}$	$\frac{4}{9}$	$\frac{16}{40}$
Subtotal	$\frac{1}{1}$	$\frac{1}{3}$	$\frac{5}{9}$	$\frac{6}{18}$	$\frac{4}{9}$	$\frac{16}{40}$
Totals (through 6/29/87)	<u>21</u>	<u>26</u>	<u>26</u>	<u>44</u>	<u>9</u>	<u>126</u>

Department of the Treasury
Office of Tax Analysis

June 29, 1987

Table 3
Revenue Estimates for Proposals Affecting Publicly Offered Limited Partnerships
(in millions of dollars)¹

Entities Affected	Include Existing Entities				Exclude Existing Entities			
	1988	1989	1990	1991	1992	1988-92	1988	1991 : 1992 : 1988-92
Tax as Corporations								
MLPs only ²								
Natural Resource	42	74	82	90	99	387	2	5
Other Industries	84	170	225	290	368	1,137	22	64
Total	126	244	306	380	467	1,524	24	69
All Publicly Offered								
Natural Resource	171	302	332	366	403	1,574	8	23
Other Industries	499	977	1,236	1,526	1,850	6,088	112	312
Total	670	1,279	1,569	1,892	2,253	7,662	120	335
Treat Income as Portfolio Income								
MLPs only ²								
Natural Resource	16	29	31	35	38	149	1	2
Other Industries	32	65	86	112	142	438	9	25
Total	48	94	118	146	180	586	9	27
All Publicly Offered								
Natural Resource	76	135	149	163	179	103	4	10
Other Industries	250	489	618	763	925	3,044	56	156
Total	326	624	767	926	1,104	3,747	59	166

Department of the Treasury
Office of Tax Analysis

June 25, 1987

1. Difference between the tax revenues estimated to be collected under the policy change noted and the estimated tax revenues for a base case which assumes that the authority to treat passive income as portfolio income is not exercised.
2. MLPs refer to publicly offered limited partnerships whose interests are traded on an organized exchange.

APPENDIX

1985 Financial Characteristics of MLPs

Appendix Table 1 provides a comparison of the financial characteristics of the average exchange-traded MLP with those of the average limited partnership, as obtained from available 1985 partnership tax returns. The information is of limited relevance, however, since MLPs now engage in a much wider range of activities, and because the current tax law restricts a taxpayer's ability to use losses generated by limited partnerships to shelter other income.

Exchange traded MLPs account for a small fraction of the limited partnership sector. For example, total MLP assets in 1985 of about \$15 billion represented only 2.5 percent of the more than \$600 billion of assets in all limited partnerships. However, the table shows that the average MLP is approximately 100 times larger than the average limited partnership. MLPs on average showed positive partnership income (Form 1065 "ordinary income") of \$15 million, compared to an average Form 1065 loss for all limited partnerships of about \$100 thousand. Even among limited partnerships with Form 1065 gains, the average gain was only about \$200 thousand. Similar differences may be noted for the average levels of debt and equity.

The income that actually flows through to the partners for tax purposes, however, differs substantially in some cases from the Form 1065 ordinary income. Ordinary income on the Form 1065 excludes expenses such as intangible drilling costs and oil and gas depletion, and certain types of income such as capital gains. Column 2 of the table adjusts for these items, and presents the average "partners' income" for the MLPs. (Corresponding information is not available to permit similar adjustments for all limited partnerships.) The table shows that the partners' income is substantially less than the Form 1065 ordinary income for MLPs in the oil and gas industry, but substantially larger than the Form 1065 ordinary income for those in the real estate and timber industries. (Several of the oil and gas MLPs were registered as tax shelters.) Indeed, while 16 oil and gas MLPs had positive Form 1065 ordinary income, only 10 had positive partners' income. Three of the real estate and timber firms had Form 1065 ordinary losses, but only one had negative partners' income.

Moreover, the taxable income generated by MLPs was low relative to the equity invested. The last column of the table reports the ratio of partners' income relative to the partners' equity. The overall average MLP showed a taxable return of 2.4 percent. The rates differed considerably by industry, with oil and gas MLPs showing only a 1.4 percent return, while the real estate and timber MLPs show a 5.8 percent taxable return. Finally, the table also shows that the level of debt incurred by MLPs was lower than that for all limited partnerships. The table shows that the 1985 debt/equity ratio for MLPs was .144, well below the average of 7.819 for all limited partnerships that year (and even below the .738 ratio for nonfinancial corporate business).

APPENDIX TABLE 1

AVERAGE FINANCIAL STATISTICS FOR LIMITED PARTNERSHIPS
FROM 1985 PARTNERSHIP TAX RETURNS¹

Type of Partnership	Ordinary Income	Partners' Income	Partners' Equity	Debt	Debt/ Equity	Partners' Income/ Equity
(-----Dollar Amounts in Millions-----)				(-----Ratios-----)		
EXCHANGE TRADED MLPs:						
ALL INDUSTRIES	15.2	7.4	266.6	38.3	0.144	0.024
Gain MLPs ⁴	21.5	9.1	305.5	40.1	0.131	0.026
Loss MLPs ⁴	-5.2	1.8	140.3	32.6	0.233	0.011
OIL AND GAS	22.1	5.1	331.6	41.7	0.126	0.014
Gain MLPs ⁴	30.1	9.5	426.6	52.1	0.122	0.020
Loss MLPs ⁴	-3.7	-9.2	27.5	8.4	0.306	-.256
REAL ESTATE AND TIMBER	4.0	11.2	161.6	33.0	0.204	0.058
Gain MLPs ⁴	7.6	8.5	111.6	21.0	0.188	0.064
Loss MLPs ⁴	-7.9	20.2	328.2	73.0	0.222	0.050
ALL LIMITED PARTNERSHIPS:	-.1	NA	0.3	2.0	7.819	NA
Gain LPs ⁴	0.2	NA	0.6	1.4	2.395	NA
Loss LPs ⁴	-0.3	NA	0.1	2.4	45.150	NA
Department of the Treasury Office of Tax Analysis				June 29, 1987		

^{1/} Of the 48 exchange traded MLPs in existence in 1985, tax information was readily available for 34. Of these, 26 had positive Form 1065 ordinary income, 8 had losses.

^{2/} Ordinary income as reported on the Form 1065 Partnership Return. This excludes certain types of income and expense such as capital gains and intangible drilling costs, which are reported on accompanying schedules.

^{3/} Partners' income equals ordinary income plus capital gains minus expenses such as intangible drilling costs, oil and gas depletion, and specially allocated items.

^{4/} MLPs with gain or loss in Form 1065 ordinary income.

Chairman RANGEL. When you were talking about the revenue losses, you mentioned transition rules. What would your idea be as to a suggested transition if, indeed, we did change the law.

Mr. MENTZ. I think, Mr. Chairman, that publicly traded master limited partnerships that are in existence today, or whatever date you pick, should remain taxable as partnerships for at least some period of time. The period is a matter of debate perhaps. But certainly they should not be cut off and immediately flipped into corporate form.

Let me just amend that slightly, however. With respect to their treatment under the passive loss rule, I think the passive loss rule is really a separate issue, and it would be possible to have a different transition rule, or indeed even no transition rule, with respect to income from master limited partnerships being treated as portfolio income rather than passive income. But on the basic characterization issue I think a transition rule that would allow maybe 5 years for existing MLPs would be a reasonable one.

Chairman RANGEL. Treasury is completing its study on the subchapter C provisions. Do you think that study might assist this subcommittee or the full committee in determining what it should do with MLPs?

Mr. MENTZ. Well, I think that the subchapter C study will consider a broad range of issues involving the corporate tax and corporate transactions. I think that perhaps in that broad framework there may be some additional insight into this issue. However, the down side of waiting is, of course, that there will be more MLPs formed in the intervening time period, whatever that is, and you will have more of a transition problem.

We are not recommending that you wait until that study is completed. Our suggestion to you as to classification of MLPs today is the same as it was June 1986, and it is a suggestion that is based on our rather full analysis of the present situation.

Chairman RANGEL. And I assume through your testimony that you believe it would require legislation as opposed to changes in regulations.

Mr. MENTZ. We think it would require legislation. That's right, Mr. Chairman.

Chairman RANGEL. Since most capital investments in the United States bear a single tax, would taxing the MLPs as corporations worsen the overall tax neutrality by subjecting some single tax investments to a double tax?

Mr. MENTZ. Well, the tax system doesn't tax all capital investment equally. Some capital investment is single taxed, like a partnership or a direct investment. Other is not taxed, such as tax exempt bonds, and owner-occupied housing. Some is double taxed.

In the face of these differences, some argue that allowing one small segment of the economy, such as MLPs, to avoid double taxation will improve neutrality because it will take you more toward a single tax system. If the goal is tax neutrality, it is more desirable in our view to tax MLPs as corporations and then provide some kind of dividend or other integration relief for all corporations, not just MLPs.

But allowing some entities, MLPs, to avoid double tax by choosing to operate as MLPs, that we think is inappropriate and funda-

mentally unfair because some entities can get there and get to the self-help integration. Another similarly situated one cannot. And that's just wrong.

Chairman RANGEL. Mr. Vander Jagt?

Mr. VANDER JAGT. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for your testimony. We are always glad to have you before the subcommittee.

I noted in your testimony and in your response to the chairman's questions that Treasury feels that whatever reclassification might take place, there should be generous allowance for transition rules. Would that contemplate grandfathering in some MLPs? Or are we strictly talking transition?

Mr. MENTZ. Well, grandfathering implies a permanent treatment as partnerships, and once you do that, you set up a very special class of entity that in perpetuity has the benefit of a tax regime that no other entity can get to.

If we were to do it in perpetuity, I think that would create such a disequilibrium that those entities would have an incentive to acquire other entities to get the beneficial tax treatment. And I think that would be the perpetuation of an unfair system. That is the reason I suggested in answer to the chairman's question that a time period of grandfather cut off at a certain period like 5 years would be, we think, probably more appropriate.

Mr. VANDER JAGT. What is the reasoning behind the recommendation that there be an exclusion in any reclassification for the energy industry? What is the rationale behind that?

Mr. MENTZ. Well, it is not just the energy industry, but the suggestion is that natural resource activities, which have traditionally been held in partnership form and have been sort of passive investments that partners have been buying into for many years, that that single tax regime be preserved like it is for real estate investors who invest in a real estate investment trust, like it is for investors in a mutual fund. It is the ability of investors to access a particular kind of asset, usually a wasting asset or an income-producing asset, that is not actively managed.

The real estate investment trust rules contain limitations, as you know, dealing with how much business activity can be conducted in the entity. And we would envision some similar kinds of limitations.

Also the REIT rules do not permit passthrough of losses. MLPs don't generally have—at least not many of them have—loss pass-throughs, but nevertheless that would also be a feature of a pass-through entity that we think would be appropriate.

Mr. VANDER JAGT. Much of the reasoning that you have given does apply, as you indicated, to real estate investments too. But as I understand it, it is Treasury's feeling that the REITs provide a vehicle for that, so that therefore MLPs wouldn't be necessary in meeting that reasoning—

Mr. MENTZ. That's right although—let me suggest this. I certainly understand the point that Mr. Andrews made about the present position of the real estate industry. And I suppose in considering a new statutory vehicle, it would not be inappropriate to look at how the REIT rules are working and see whether you want to make any changes there.

But it seems to me that we ought to have one entity per type of activity and not more than one.

Mr. VANDER JAGT. I think one of the strengths of your testimony was that you indicate an awareness of the complexity of this and the difficulty of defining just what it is that ought to be done. Why wouldn't it then be better to wait until the study is completed, the study that was called for in tax reform, so that we have a more comprehensive idea of where it fits in the context of everything else and know more precisely what it is we are doing?

Mr. MENTZ. That is a perfectly logical and rational approach, Mr. Vander Jagt. At present our study will not directly deal with MLPs. It will consider a broad range of corporate issues.

I suppose if you were to decide that we ought to have corporate-shareholder integration, that would bear on the MLP issue. I think there is maybe a little revenue problem in coming to that conclusion.

I guess you have to weigh the question of whether you think the study will add to our knowledge and basic understanding of the whole corporate area on the one hand, and on the other hand is the problem of more MLPs being created in the meantime that would be given some kind of transition relief. That is really the equation.

Mr. VANDER JAGT. Well, thank you very much, Mr. Secretary. And thank you, Mr. Chairman.

Chairman RANGEL. Mr. Dorgan?

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Mentz, I was looking at your testimony and listened to your response to the chairman and his questions. I was curious. On the question of the subchapter C study, you indicated to the chairman that we probably should not wait. In your written testimony you say there would be some logic in Congress delaying full consideration of this issue. I wonder what really is the position of Treasury.

Mr. MENTZ. I guess, to restate what I just said to Mr. Vander Jagt, there is clearly some logic in waiting, Mr. Dorgan. And I think the logic and the—the benefit is you get a broader view of what changes might possibly be in the works for corporations and corporate transactions. As you know, the impact of *General Utilities* is an important facet of that study and how that interrelates with stock acquisitions and asset acquisitions will be considered in depth in the study. That is the advantage of waiting.

The disadvantage of waiting is the study itself will not specifically address MLPs. I think unless there is some dramatic change in what is happening with MLPs, we think we have studied it about as much as we can study it. And the disadvantage is that you have more MLPs being created between now and then. And that is really the tradeoff.

Mr. DORGAN. The answer is there would be some logic in delaying full consideration, but we shouldn't wait.

Mr. MENTZ. Well, I think there is some logic in delaying, and there's some logic in not delaying.

Mr. DORGAN. I think all of us and you, Mr. Mentz, are concerned about the revenue impact. That is what really drives the major concern. Could you give me some indication of what percent of the projected revenue loss is represented by the passive income fea-

ture? If we treated that passive income as portfolio income, what percent of the revenue problem would be resolved with respect to MLPs?

Mr. MENTZ. Well, I'll give you two answers to that. The table at the back here—I think it is table 3—indicates the upper half of that is taxing as corporations—in other words, the full-blown corporate treatment. And if you look at excluding existing entities and take only MLPs, not publicly offered partnerships you will see the number of \$665 million on the right-hand side for 1988 to 1992. That is your total revenue that would be gained under our estimates from classifying them as corporations but with a grandfather rule that grandfathers all existing MLPs.

The corresponding number for the passive income is, if you look down to "Treat Income as Portfolio Income," all the way over to the right-hand side you'll see \$260 million. So, roughly a little more than a third is relating to the passive loss rule.

But that's a little bit misleading because our great concern isn't so much with the revenue that we would pick up. This is not a lot of revenue. But if we don't do something about MLPs, you are talking about a very much greater amount that we would lose because here's a way around that tax law that we passed last year that increased taxes on corporations. And those who can get there will get there.

Now, we were unable to estimate that. I wish I could give you a better number for it, but I can't. But if you look at what is happening, you see the trends. And you even see the trends of how the revenue goes. It is a lot higher—as you get further out, the revenue that you gain increases. So, I think it is a troublesome trend, and that's the reason we are here this morning.

Mr. DORGAN. If you set aside the passive income issue for the moment, are there master limited partnerships that have little or no impact on Federal revenues?

I guess the question we are trying to get at here is how much MLP's could cost the Federal Government. If you were to treat passive income as portfolio income and resolve that problem, are there master limited partnerships that are formed for their own reasons that have almost no impact on Federal revenue? If so, what kind of partnerships would they be?

Mr. MENTZ. Well, I think that master limited partnerships fundamentally are formed because they are able to enjoy the tax advantage of single taxation, no entity level tax. And it is not just the passive loss rule. Certainly someone who didn't have passive losses—there would still be an economic advantage to operating in partnership form. And that is true of every MLP. The only MLP that it is not true of would be one that doesn't have any income for tax purposes. But if there is income, then it is beneficial to have it taxed singly rather than doubly.

Mr. DORGAN. I was looking at the Wall Street Journal report this morning, which I thought was an interesting piece on this subject. It described a number of master limited partnerships that have been formed. And I saw a television report recently on one, a sports franchise, which shall remain unnamed, the Boston Celtics. [Laughter.]

As I understand it, the Boston Celtics retained a substantial amount of that ownership and then moved part of it out under a master limited partnership. So, over 50 percent of that business entity is going to retain double taxation at the corporate level. Correct?

Mr. MENTZ. That's right.

Mr. DORGAN. So, even in those kind of rollout MLPs you don't have a case where you wash it out into an MLP where you have a revenue consequence for the full entity.

Mr. MENTZ. That's right. And that is true in a number of the oil and gas rollouts as well. The corporate sponsor frequently retains a significant interest in the MLP. And you're right. It is only the partnership interests that are held publicly that enjoy the single tax. Obviously the corporate sponsor is going to be subject to its own corporate tax. And that is in these figures, of course.

Mr. DORGAN. In terms of the assertion that this could be an epidemic, that is, the formation of MLPs from a corporate structure, can you give us some analysis of how the repeal of the *General Utilities* doctrine impacts on the liquidation of a corporation into an MLP?

Mr. MENTZ. Well, sure. There is some analysis in the testimony. And just briefly, the repeal of *General Utilities*, effective January 1, 1987, made possible or drove the formation of some MLPs in late 1986. Corporations could liquidate without a *General Utilities* corporate level tax into a master limited partnership.

That is no longer possible except for some that are granted transitional relief under *General Utilities*. But generally speaking, General Motors could not disincorporate today without a *General Utilities* tax.

But because of the advantage of operating in unincorporated or single tax form is so strong, as indicated by the statistics I gave earlier, businesses that start up are either forming as MLPs or forming as limited partnerships with the potential of becoming MLPs when they go public. So, there are other creative ways to get into MLP status besides liquidation.

And when there is such an economic drive to getting there, the creativity of the tax bar and the tax accounting profession is such in this country that they will find ways to do it.

Mr. DORGAN. One other question, if I might. I believe it was the article this morning that I was looking at. I don't see the quote now, but one of the experts that was interviewed suggested that you will never see General Motors form an MLP.

I assume at least there is an offset here with respect to an incredibly complex system of bookkeeping and accounting that is required to keep track of things in an MLP that is probably not the case in a corporate structure. Some assertion that there would be an epidemic here and a wholesale movement to MLPs. Can you give me some example of what kinds of corporations naturally would want to move in that direction?

Your testimony seems to suggest that there is a certainty of tax benefit in every instance. If that's the case, how is that offset by the other complexities and the difficulties and the roadblocks or obstacles to forming MLPs? Can you give me your analysis of that?

Mr. MENTZ. Well that is a good question.

Over the past 6 years we have seen an evolvement of MLPs. In the beginning, back in 1981, MLPs—there were very few of them, and probably the primary reason for the paucity of MLPs was the complexity in keeping records and indeed the fact that even those best-intentioned MLPs are not actually in strict compliance with Treasury regulations. It is very hard if a limited partner in an MLP buys into the MLP tomorrow or Thursday, July 2, and goes out on July 29, there is not going to be any tax on any income during that period to him because they just don't have the ability to handle that as a matter of recordkeeping.

There has been an evolvement of computer software that makes possible the maintenance of MLPs, and a good faith attempt to comply with the complexity of recordkeeping. But complexity of record keeping is a disadvantage to some. Perhaps a more significant disadvantage is in some cases there will be a cost to getting into an MLP. Even if you didn't have *General Utilities*, there is a shareholder level tax for disincorporation. So, there are some costs.

I'm not suggesting that every corporation is going to go out and get into MLP form. But I think what we can conclude, and we can conclude it from the empirical evidence is that the roadblocks to setting up MLPs—"it's too complicated, it's too much trouble; don't bother me with that new idea, investment banker"—are being eroded because of the significant economic advantage under our current tax system of being in MLP form.

And I am extrapolating. There is no question. I am saying I think this will happen. I think there will be more. I think there will be a hemorrhage. That is my best judgment based on everything we have studied. And I think it is right.

Mr. DORGAN. Mr. Mentz, thank you very much. I think again most of us are trying to understand something that is relatively new and something that is not very easy to understand. We're trying to understand what drives it, what effect it will have. I appreciate your testimony.

Mr. Chairman, I would like to submit some questions to Treasury and because of the limited time here, I would hope that the Treasury could respond to the questions that we might submit to you in relatively short order.

Mr. MENTZ. I would be pleased to do that, Mr. Dorgan.

Chairman RANGEL. Without objection.

[The questions and answers follow:]

RESPONSE TO REPRESENTATIVE DORGAN

I. (a)

QUESTION: What are the primary factors regarding MLPs that cause a significant revenue loss to Treasury?

ANSWER: There are several factors that cause the rapid growth of MLPs to lead to a revenue loss. First, in contrast to a corporation, the income earned by an MLP (other than the share allocable to the corporate sponsor) is not subject to an entity level tax. Second, the losses incurred by an MLP may be passed through to the public investors and used to offset (subject to limitation) the investors' other income, whereas such losses when incurred by a corporation may merely lead to an increased net operating loss deduction. Third, unlike dividend income, the MLP gains passed-through to the individual investors may be offset by the investors' passive losses.

I. (b)

QUESTION: To what extent would the revenue pick-up you have attached to MLPs be accomplished by treating MLP income as portfolio income, rather than passive income?

ANSWER: As shown in Table 3 of my testimony, during the fiscal year 1988-1992 the revenue pick-up estimated to result from treating MLP income as portfolio income is approximately forty percent of the estimated revenue pick-up resulting from taxing MLPs as corporations. For example, if exchange traded MLPs formed after 1987 are taxed as corporations, a fiscal year 1988-92 revenue gain of \$665 million is expected. If such MLPs were to continue to be taxed as partnerships, but the MLP gains treated as portfolio income, a five-year revenue pick-up of \$260 million is expected.

I. (b)(1)

QUESTION: In making such a calculation, did you provide that investors could carryover and offset losses from an MLP against income derived in later years from the same MLP? What other assumptions did you make? If not, on what policy basis would you prohibit such treatment, since it is in stark contrast to other areas of the Code where such carryovers are routinely permitted, such as loss carryforwards?

ANSWER: The revenue estimates assume that investors in a MLP can utilize losses from the MLP to offset future MLP gains.

I. (b)(2)

QUESTION: Based on the disproportionate effect of this one factor, why should we not just resolve this one issue now and wait to attend to the other more technical, less revenue-driven issues, in conjunction with full subchapter C reform, after a more complete and reasoned study?

ANSWER: I believe our current examination of the MLP issue has been rather extensive, and that our conclusions are based on sound analysis. It is also the case that the longer the delay in acting, the more severe would be the resulting transition problem. Based on the recent growth in MLPs, from 25 to 50 new MLPs might be formed by the time the Subchapter C study is expected to be submitted to the Congress.

I. (c)

QUESTION: Absent the passive income generation issue, what kind of MLPs have little, or no, adverse effect on Treasury revenues?

ANSWER: In terms of the initial impact, roll-up MLPs do not result in a revenue loss aside from the passive loss rule effect. However, all MLPs have some potentially adverse effect on Treasury revenues because they all can attract new capital that otherwise would have been invested in the corporate sector.

I. (c)(1)

QUESTION: Since most of the interests in roll-outs are still retained by the corporate sponsor and thereby still are subject to the dual-level tax, would you please explain where you believe the revenue effect is?

ANSWER: In estimating the revenue gains resulting from taxing MLPs as corporations, only the income from public (non-corporate) investment in MLPs was included. The data utilized thus excluded the sponsoring corporation's ownership share of the MLP.

I. (c)(3)

QUESTION: Since, in forming a liquidation MLP, the corporate sponsor either has already recognized any built-in appreciation in its assets or has recaptured certain amounts as income, why would this type of MLP adversely impact Treasury revenues? Why would there be any significant new liquidation MLPs in light of the repeal of the General Utilities doctrine? How do you propose that we treat existing liquidation MLPs, since the built in appreciation and recapture items have already been recognized and taxes paid?

ANSWER: The formation of a liquidation MLP is likely to initially result in a revenue gain, especially with the increase in individual capital gain rates and the repeal of the General Utilities doctrine. However, for that very reason it is not expected that many liquidation MLPs would continue to be formed, except perhaps in those cases where the liquidating corporation has sufficient net operating losses with which to offset the gains recognized upon the liquidation. Since the basis of the assets of liquidation MLPs would be stepped-up to market value at the time of formation, subsequent operation of such MLPs would generate less taxable income than would have been the case had the assets been retained by the corporation, and the income generated is subject to only a single level of tax (which may be offset by passive losses absent classification as portfolio income). Thus, even if new liquidation MLPs were to be formed, the initial revenue gains would be followed by revenue losses. As I have already indicated in my testimony, I believe that some transition relief should be given to all existing MLPs, not just liquidation MLPs.

I. (c)(4)

QUESTION: Since acquisition MLPs offer an equity raising alternative to debt-financing LBOs, why should we discourage their use by taxing them as corporations?

ANSWER: There are indeed important issues that should be examined regarding the appropriate classification of securities (many of which are issued in LBO's) as debt or equity. Tax and non-tax concerns about excessive debt capitalization should be dealt with directly. Such concerns should not preclude the proper tax classification of MLPs.

I. (c)(5)

QUESTION: In ascertaining your revenue estimate, what proportion of MLP interests in the marketplace did you figure remain held by the corporate sponsor, or are held in MLPs that would have been formed as partnerships even without tradeability?

ANSWER: The Office of Tax Analysis' revenue estimates were based on the level of publicly held MLP investment, not on the corporate sponsor's share of the MLP interests. Nevertheless, data supplied to Treasury by Robert A. Stanger & Co. indicates that about 60 percent of total MLP equity is held by the general partner, which may be assumed to be the corporate sponsor. The estimates also assume that if MLPs were to be taxed as corporations, about 30 percent of the equity which would have been invested by the public in MLPs would instead be invested in non-publicly traded partnerships (and thus would not contribute to the revenue pick-up).

I. (d)

QUESTION: What are the adverse effects to the Treasury of taxing MLPs as corporations rather than as partnerships? What impact does the use of debt borrowed from tax-exempt institutions and investment made by tax-exempt institutions in corporations have on the combined effective tax rate paid by corporations on their income and by their shareholders on corporate distributions?

ANSWER: The revenue estimates assume that the overall level of debt in the economy and the overall level of funds invested by tax-exempt entities do not change significantly. Thus, the revenue impact of the fact that a given firm borrows more or that a greater share of its equity is held by tax-exempt entities is expected to be largely offset by changes in the financial structure and ownership of other firms. Moreover, there are other alternatives to raising funds through MLP offerings in addition to increased corporate borrowing, such as the sale of corporate stock or corporate assets. Thus, while it is expected that the revenue gains arising from taxing MLPs as corporations will be partially reduced by various portfolio shifts by investors and changes in corporate investment and financial decisions, the analysis indicates that taxing MLPs as corporations will unambiguously recapture tax revenues which would otherwise have been lost.

II. (a)

QUESTION: Is Treasury proposing the complete elimination of partnership taxation?

ANSWER: No. The only partnerships that we propose to tax as corporations are those that are publicly traded.

II. (b)

QUESTION: If not, what businesses do you believe are still appropriate to be conducted in the partnership form?

ANSWER: We believe that the partnership form is appropriate for businesses which both choose to be organized as partnerships and otherwise satisfy the current classification regulations and which are not publicly traded. In addition, a more administrable form of single level tax structure is still appropriate for publicly traded partnerships conducting passive activities that have traditionally been conducted in partnership form, such as certain natural resource enterprises.

II. (c)

QUESTION: Why do you recommend that we revise the current classification rules? Would you recommend that such changes be limited to impact MLPs only? How would you define an MLP for this purpose? How do you distinguish between MLPs and privately placed or registered but unlisted securities?

ANSWER: The current classification rules are biased in favor of partnerships. During the past several years, it has become apparent that the application of these rules has allowed certain organizations that are substantially identical to corporations to avoid the corporate income tax in a way that is unavailable to other businesses. Thus, we recommend revising these rules generally to classify these organizations as corporations. In our view, the MLP form or organization is sufficiently similar to the corporate form to merit reclassification as a corporation. For this purpose, master limited partnerships would be defined as limited partnerships whose interests are publicly traded. In most cases, the application of the revised classification rules would be clear: privately placed partnerships would not be reclassified, publicly offered partnerships that were listed on national exchanges would be reclassified.

Only the determination of the proper treatment of registered but unlisted partnerships where there was a frequent exchange of interests would require further analysis.

II. (d)

QUESTION: What is the reason to discriminate against larger partnerships as compared to smaller partnerships? Doesn't your dividing line between larger MLPs and smaller partnerships create inconsistent tax policy? Doesn't it favor the wealthy who can afford illiquid investments and own units in small partnerships or as sole proprietors, thereby avoiding corporate taxation?

ANSWER: It must be recognized that as long as some business income is subject to two levels of tax and other business income is subject to a single level of tax (that is, until complete integration of the corporate and individual tax system is achieved) inconsistent tax treatment and discrimination against the businesses subject to two levels of tax is inevitable. The only issue is to determine the most fair, administrable, and fiscally responsible way to distinguish among different businesses.

Our proposal would not distinguish among partnerships on the basis of size but only on the basis of public trading. Indeed, our proposal would not affect many large publicly-offered partnerships that are not publicly traded. Our proposal is intended to eliminate an inconsistency in existing tax policy between businesses with similar characteristics that receive different tax treatment simply because one calls itself a corporation while the other calls itself a partnership.

We are not persuaded that our proposal favors the wealthy in any meaningful sense. Although individuals of modest means would have fewer opportunities to invest in certain partnerships, they would not be noticeably worse off. What matters is not the amount of taxes paid on their investments but the after-tax return they receive. Since the wealthy freely invest in both the corporate and noncorporate sectors, it is reasonable to believe that the risk-adjusted after-tax rates of return in the two sectors are equalized.

Small investors would continue to be able to invest in other businesses subject to a single level of tax, such as REITS and REMICS. In addition, we have suggested a new pass-through entity for natural resources, which also would be available for small investors.

Chairman RANGEL. Mr. McGrath?

Mr. McGRATH. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

I, as an aside, find it interesting that your two immediate predecessors find themselves on the other side of the issue.

Mr. MENTZ. Did you say "immediate" or "obedient"? [Laughter.]

Mr. McGRATH. Immediate. And I frankly wonder when you go back to your old life whether or not you will be giving us the same testimony that you are giving today. [Laughter.]

Mr. MENTZ. Well, I tell you, Mr. McGrath, when my old life—if you leave the law the way it is, I'm going to go out and I'm going to create as many MLPs as I can.

Mr. McGRATH. Well, that's what I wanted to talk to you about. [Laughter.]

Mr. MENTZ. How can I be helpful?

Mr. McGRATH. You are assuming in your testimony—I don't know whether your revenue assumptions on table 2 jibe with the number of MLPs that have been formed—I should say the revenue estimates on table 3 jibe with the number of MLPs in table 2. I am just wondering given the two whether you are suggesting that 40 MLPs are going to create \$7.6 billion in revenue or we're going to lose \$7.6 billion in revenue because of the creation of 40.

Mr. MENTZ. No, I'm not. In fact, the \$7.6 billion is a figure that would—that would be the number if you treated all publicly offered limited partnerships as corporations. We are not suggesting that. That isn't even on the table as far as I'm concerned.

Mr. McGRATH. Well, what are you suggesting?

Mr. MENTZ. That is merely an outside number, so you know what the outside revenue pickup would be.

Mr. McGRATH. What are you suggesting would be the revenue loss with the present number of MLPs? There seems to be some discrepancy between the journal article of 99 and yours of 40 that have been established as of today.

Mr. MENTZ. Well, I think our testimony says that we have got—we can identify 127 I believe it was.

Mr. McGRATH. That's not what table 2 says.

Mr. MENTZ. Well, table 2—no, no. Forty is for 1987. That is not a total of all of them.

But let me tell you how these tables are put together. The publicly offered—again, every limited partnership that is publicly offered, whether or not it is publicly traded—the vast majority of publicly offered partnerships are not publicly traded. So, that is a theoretical figure measuring simply the outside boundary.

The numbers on MLPs alone, including the existing entities—it's \$1.5 billion. That assumes not just the existing entities from 1981 to 1987, but it assumes a level of growth of MLPs, and it assumes—it's probably a fairly minimal level of growth beyond the time that the window closes. But it also assumes some shifting from MLPs to other let's say non-publicly traded limited partnerships.

In other words, there is a behavioral effect. If a company can't go into an MLP, some companies will say the heck with it. We'll stay with the corporate form. Others will say let's find a nonpublicly traded vehicle that we can put some of our assets into and enjoy

the same single tax. That's the basis of those tables. And that is different than the revenue you would lose by doing nothing.

Mr. McGRATH. What worries me somewhat is the circumstance that this committee is going to find itself in sometime in August or even sooner, and that is to come up with \$19.3 billion in revenues. Now, if the administration through your testimony comes here and says that somewhere out there there is anywhere between \$1.3 and \$7 billion outstanding, I am sure that the chairman is going to use that as money to satisfy the reconciliation number. And my question to you is whether or not this is an independent judgment of the Assistant Secretary of the Treasury or this is administration policy we're hearing today.

Mr. MENTZ. Well, obviously the number that you are going to have to focus on will be the Joint Committee number—that's the way you get to your revenue number, whatever it is.

Mr. McGRATH. We haven't seen that yet.

Mr. MENTZ. That's right. But I don't think you will find them too different than Treasury numbers because there is a good bit of coordination on this analysis, which is complex.

Just to tell you what the administration position is, as you know, the administration is not supportive of the \$19.3 billion. The President's budget has revenue enhancers that I testified on several months ago of \$6.1 billion. And that is where the administration stops. So, you will not find support from the administration for \$19.3 billion.

Mr. McGRATH. I understand that, Mr. Mentz. And my problem is that I am going to have to vote on it—and I recognize that the budget resolution does not bind the executive branch of government, nor the President, nor the Secretary of the Treasury.

However, we are going to have to vote on something that is going to be presented to us. And if we have to come up with \$19.3 billion, we all recognize up here, as you do, how difficult a proposition that is. That's a lot of money.

Now, if we can pick up revenue or somebody says, well, here's a way of eliminating our problems with increasing excise taxes on beer and wine and whatever, we're not sitting down the other end of Pennsylvania Avenue saying we're not going to sign anything. We're going to have to either vote or not vote on a package that is presented to us with a lot of these numbers in them. And frankly, I just wonder if the administration is not going to sign off on any revenue measure to satisfy our budget resolutions, why we should be discussing this in the first place.

Let me ask you another question while I'm at it. Do you find that these master limited partnerships are more or less risky to the unit holder than owning a share of stock?

Mr. MENTZ. I think it is basically no different. And I don't think too many investors are aware that they are into master limited partnerships. Someone who owns a New York Stock Exchange traded MLP, Mesa Petroleum for instance—typically the investor—his accountant will know, but typically the investor won't know.

Mr. McGRATH. Well, whether or not he knows, is it more risky or is it less risky knowing that the SEC has no participation in these particular entities?

Mr. MENTZ. They are publicly sold and traded on the stock exchange. So, they are subject to the Securities Act of 1933 and the Securities and Exchange Act of 1934. The SEC has the same regulatory jurisdiction over MLPs as they do corporate stock.

There may be potentially some greater liability for a limited partner. I'm not really up on my partnership law, but I think there may be some infinitesimally greater risk of being a limited partner than being a shareholder. The market I think basically discounts it to insignificance.

Mr. McGRATH. Of the 100 to 127 MLPs created, what percentage of the units of the MLP have been retained by the corporate sponsor and how many are let for public trading? And has that been factored into your revenue numbers?

Mr. MENTZ. That definitely has been factored in. I'll get you those numbers. I don't have them, Mr. McGrath, at my fingertips, but I can certainly—we will get them for you.

Incidentally, why are we discussing this? I think you ought to be discussing this even if there were zero revenue involved in 1988 or the budget period because if you don't look at it, you're going to be faced with bigger deficits, revenue hemorrhage, and you're going to have problems down the road. It's a fundamental problem for tax reform. You are trying to pick up a significant amount of money out of the corporate sector. If you have a significant part of that sector disincorporating, you're not going to make it.

Mr. McGRATH. What about the argument that corporations which do not go in this route would not be able to generate the amount of revenue they need in order to conduct their business? Doesn't that have something to say about the revenue estimates?

Let's say somebody is constricted as a corporation to being taxed on two levels as opposed to going the route of MLP and their ability to raise capital funds through this source. Wouldn't that capital formation have some effect on revenues and the taxes that would be able to be recouped from more business and more—

Mr. MENTZ. I think I see your point. You mean, is there an effect on the non-MLP corporation that has a double layer of tax. Will that corporation because of the existence of MLPs be disadvantaged, and therefore have lower income, and therefore pay lower tax? Is that basically—

Mr. McGRATH. Well, you could do it that way, but let's say a corporation needed an infusion of capital and they could not get it as a corporation, but they can get it as an MLP. Given the differential between the tax rate of a corporation and the tax rate of an MLP, couldn't a scenario be constructed where the Treasury would gain more revenue through the construction of these MLPs than to have an undercapitalized corporation?

Mr. MENTZ. I don't think there is a scenario in which the Treasury will gain. I think that would be extremely unlikely. I don't have a handle on the exact answer to your question. Let me get it for you.

Mr. McGRATH. Okay. Well, thank you, Mr. Chairman. Thank you, Mr. Mentz.

Chairman RANGEL. Mr. Mentz, I don't know whether I understood your answer to Mr. McGrath, but—

Mr. MENTZ. I'm not sure I did either.

Chairman RANGEL. Is it the administration's view that this measure is a tax reform recommendation and not a tax increase?

Mr. MENTZ. That's right. This measure is basically preventative. It is to avoid what we think at Treasury is going to be a revenue loss that is going to erode the underpinnings of tax reform. Remember, our rate reductions, both the corporate and particularly individual, are built on significant revenue increases on the corporate side. That is the underpinnings. If those are eroded, the revenue neutrality of tax reform is going to be jeopardized.

Chairman RANGEL. I just wanted to get the language clear because you were talking about \$6 or \$7 billion in revenue enhancement, and I didn't want this to be included with a tax increase knowing the President's position on taxes.

Mr. MENTZ. Thank you for clarifying that.

Chairman RANGEL. Mr. Andrews?

Mr. ANDREWS. Thank you, Mr. Chairman.

Mr. Secretary, I wonder if you would sort of help me put this into historical perspective. As I understand your testimony, during the debate on tax reform you presented this testimony I assume to the Senate. I don't believe there were hearings on the House side on MLPs, were there?

Mr. MENTZ. Yes, it was to this committee, this subcommittee.

Mr. ANDREWS. Did you make the recommendation at that time that they should be taxed as corporations?

Mr. MENTZ. Yes, on June 9 of last year, which of course was after the bill was through both—it was on the Senate floor I guess—we made the suggestion here that MLPs ought to be taxed as corporations.

Mr. ANDREWS. But it was after the bill had passed the House?

Mr. MENTZ. That's right. It had passed the House. It had passed the Senate Finance Committee, but it was before the Senate floor, and of course, it was before conference.

Mr. ANDREWS. And your recommendation at that time was rejected.

Mr. MENTZ. It was not acted on. [Laughter.]

You might call that rejected. I wouldn't, but you might.

Mr. ANDREWS. In 1983 I understand that the Treasury Department testified in favor of master limited partnerships. Is that correct?

Mr. MENTZ. I believe that is correct.

Mr. ANDREWS. Well, help me out a little bit.

Mr. MENTZ. And in 1984 Treasury concluded that all limited partnerships with more than 35 partners should be taxable as corporations. That was part of Treasury 1.

Mr. ANDREWS. Well, explain to me then why the direct change in policy on the part of Treasury.

Mr. MENTZ. I don't know the reason, Mr. Andrews, for the 1983 position. I think it is wrong. And I don't know—and frankly, I think the 1984 position is too extreme. If you tax all partnerships with more than 35 partners, on table 3 you will be picking up all of the publicly offered, probably plus some. And I think that is going way too far, and that's the reason that never found its way into the law.

I think maybe if we start over there and maybe sooner or later we get somewhere to the middle, and that's where I'm trying to get. And what I'm trying to get is that an entity that is identical in all economic respects to a publicly traded, exchange-traded, corporation—its shares are on the New York Stock Exchange. It has 10,000 employees. It issues stock options in MLP units. It makes acquisitions with those units. It has different kinds of shares, class A, class B, class C, just like a corporation. It has debt, often significant debt. I think that entity for all intents and purposes in a corporation.

Mr. McGRATH. Will the gentleman yield?

Mr. ANDREWS. I'd be happy to yield.

Mr. McGRATH. It seems to me, having been involved in that expedition called tax reform, that it was the administration itself that pulled back on the 35 member rule of the partnership in going from Treasury 1 to Treasury 2.

Mr. ANDREWS. The point of my question, Mr. Mentz—you know your idea of what is the middle ground on this issue and what the committee's idea of what is the middle ground on this policy are pretty far apart. I'm in a sense trying to determine some consistency of public policy in trying to send an appropriate message out to the market place. I am troubled by a position that diametrically changed in a very short period of time. These started in 1981. In 1983 the Treasury Department thought they were fine. And now your position in my view is not in the middle but a dramatic change from the testimony of 1983.

Mr. MENTZ. Well, in 1983 there were eight. In 1981 there were three. In 1982 there were five. So, by the time our testimony came around in 1983, there were only eight master limited partnerships, and they were virtually all—they were all in oil and gas except for one in real estate and one in timber. So, I think quite frankly, Mr. Andrews, the situation has changed a lot, and it is changing rapidly.

Mr. ANDREWS. That's a good point. I suppose the next question is how big is big. Is 126 big?

Mr. MENTZ. Well, look at it this way. Five percent of the equity raised in public offerings last year was raised by MLPs. Five percent is not insignificant. Incidentally, that was a big year for corporate offerings, \$60 billion odd was the publicly offered stock. So, I think it is big enough to worry about, Mr. Andrews.

Mr. ANDREWS. About how many of the 126 are energy related companies?

Mr. MENTZ. Well, let's see. I get 38.

Mr. ANDREWS. Thirty-eight—

Mr. MENTZ. Yes.

Mr. ANDREWS [continuing]. Of 126 are energy.

Mr. MENTZ. Right.

Mr. ANDREWS. Now, you suggested in your opening testimony that should the Congress make a change, that we should address the particular industry of oil and gas.

Mr. MENTZ. Natural resources.

Mr. ANDREWS. Natural resources.

That troubles me just a little bit. Being somebody that represents a lot of natural resources, I supposed I should say thank you. But

in the sense of trying to view this in the context of what the committee should do in terms of public policy, I'm curious how we distinguish and carve out an exception for natural resources as opposed to, say, real estate. I can understand the Boston Celtics, but I have a hard time understanding the difference between oil and gas exploration and homebuilding and whether that kind of change would withstand the light of criticism. You said a few moments ago that they're wasting assets, not actively managed.

Chairman RANGEL. I'd like to join the gentleman—

Mr. ANDREWS. Is that a test?

Chairman RANGEL [continuing]. In that question as to why oil and gas as opposed to natural resources was carved out.

Mr. MENTZ. Well, I am basing that on what Congress has already done with real estate investment trusts, regulated investment companies, and more recently REMIC entities to hold mortgage pass-through securities.

I think the notion is—it certainly was in last year's debate on real estate investment trust changes—that if an entity is basically not a business, not the Boston Celtics, not a gas pipeline with 10,000 employees, but is a passive collection of assets, the income from which is being distributed to the investors, then Congress saw fit to make a single level of tax, a limited passthrough model. Losses don't pass through, but limited passthrough, income treated as portfolio income for the passive loss rule. They saw fit to adopt that model.

I think a good case can be made that a similar model fits passive investments in natural resources. If you, Mr. Andrews, would like to oppose it, I suppose you have that flexibility.

Mr. ANDREWS. Well, I appreciate your giving me the opportunity. [Laughter.]

The point of my concern and the point of the chairman's concern is if you're right, you're right. To suggest a large portion of this 126 should be okay, based on this test of wasting assets, not actively managed concerns me. It troubles me. I am not sure how I could sell that to my chairman and those of my colleagues from other parts of the country.

Mr. MENTZ. I understand.

Mr. ANDREWS. And I'm not sure how you can either, Mr. Mentz.

Mr. MENTZ. I understand what you are saying. I think if you look at the numbers here, the oil and gas entities have been really fairly constant, in fact, even going down the last couple of years.

I think the issue is very similar to the real estate investment trust. If we want to be very pure about it, we can say, well, corporate taxation, a double level tax is the norm in this law, and in a pure system, let's get rid of the real estate investment trust. Let's get rid of the REMIC. Let's get rid of subchapter S. You know, go the whole distance.

I am not suggesting that. I am suggesting that life is a practical matter, and I think a practical solution here involves a separate vehicle for natural resources. I think it makes good sense.

Mr. ANDREWS. Do your numbers and revenue calculations include natural resources?

Mr. MENTZ. Yes, they do. In fact, they are broken out separately if you look at the next page, if you look at table 3. Natural re-

sources is separately stated. And you will see, particularly if you grandfather them, you have got very little revenue, \$47 million over a 5-year period. You are talking about an asterisk.

I'm not up here trying to change the world as far as natural resources are concerned. But I really am concerned about these active businesses that are doing an ad hoc integration that you all have not approved of by law.

Mr. ANDREWS. On the short term, give us your thoughts about the revenue estimates?

Mr. MENTZ. Well, on the short term, I guess if I had to pick my preference on this revenue table, it would be either MLPs only or somewhere a little bit further down on that, but certainly not to all publicly offered. And it would raise, as you see, about \$665 million over 5 years. If you take out natural resource, you've got \$618 million. That is not going to be the kind of revenue that is going to make your 19.2 or even the President's 6.1.

Mr. ANDREWS. Well, I think that was one of the points that Mr. McGrath was trying to make. As we go about trying to get \$19.3 billion in revenues you are suggesting to the committee that this should not really be significant.

Mr. MENTZ. Well, I'm suggesting that in absolute dollars, I think the Joint Committee numbers are not going to be too different from this. So, you're not going to raise a whole lot of revenue in the short term from doing this. But if you don't do it, you're going to be out a lot of revenue further out, and the revenue loss from inaction is much more significant than the revenue pickup from doing this.

But I would be advocating it even if I showed no revenue on these numbers.

Mr. ANDREWS. Does your table take into account, assuming that MLPs would be taxed as corporations, that those same activities would be operated in some other passthrough method?

Mr. MENTZ. It does take into account behavioral effects. It takes into account that if MLPs are taxed as corporations, that there will be some businesses that will be able to move one step further away and into a non-publicly traded form or some other kind of pass-through vehicle. That is—

Mr. ANDREWS. Or increase their level of debt.

Mr. MENTZ. Well, or increase their level of debt although I recognize and Treasury recognizes that unlimited increases in levels of debt is another form of ad hoc integration. It is the elimination of a corporate level tax. We have in the Internal Revenue Code, section 385, which provides Treasury with authority to impose some limitations on that. In the early 1980's an attempt was made unsuccessfully to put out regulations.

We think that is something that needs another look because there is no question that corporate level debt, particularly in some of the most egregious deals where it is 100 to 1 debt to equity ratio. That is also a revenue problem. I think that is a problem. Treasury has got to consider it. We will either do something about it with regulations or be back to you on it. That is a separate issue.

Mr. ANDREWS. Well, I respect your fervor about this issue. However, I continue to be curious as to why you are so aggressive in wanting to move ahead right now. Why don't we wait for the

Treasury study? In looking at the short-term revenue numbers that you have just discussed, why don't we wait for the Treasury study?

Mr. MENTZ. Mr. Andrews, that is a perfectly logical position to take.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Brown?

Mr. ANDREWS. Mr. Chairman, I have several written questions, and with the chairman's permission I would like to submit those to the Secretary.

Chairman RANGEL. Without objection.

[The questions and answers follow:]

RESPONSE TO REPRESENTATIVE ANDREWS

1. (a)

QUESTION: Have the revenue projections taken into account:

- a) The impact of the alternative of debt financing that would have been incurred by the corporations who have formed these PTLPs? This leverage would create interest deductions which might not be offset with taxable income due to the tax-exempt status of many lenders.

ANSWER: The revenue estimates assume that the overall level of debt in the economy and the overall level of funds invested by tax-exempt entities are not significantly changed. Thus, the revenue impact of the fact that a given firm borrows more or that a greater share of its equity is held by tax-exempt entities is expected to be largely offset by changes in the financial structure and ownership of other firms. Moreover, even in the case of the sponsoring corporation, the offering of PTLP interests substitutes to some extent for the offering of corporate equity or the sale of corporate assets.

- b) The revenue gains to the Treasury from taxes recognized on the formations of these PTLPs?

ANSWER: The revenue estimates reflect the taxes recognized on the formation of PTLPs.

- c) The capital losses that will be created for unitholders that currently own units and who will suffer great declines in the price of their units?

ANSWER: The revenue estimates attempt to allow for the induced portfolio shifts and the resulting tax consequences of such shifts.

- d) The fact that double taxation is already in effect to the extent that corporations own an interest in these partnerships?

ANSWER: In estimating the revenue gains resulting from taxing PTLPs as corporations, only the income from public (non-corporate) investment

-2-

in MLPs was included. The data utilized thus excluded the sponsoring corporation's ownership share of the PTLP.

2.

QUESTION: Is it not more equitable to grandfather existing PTLPs? Due to the complex transition rules which would be required to tax existing PTLPs as corporations, do the questionable benefits justify the time and expense of studying, creating, implementing, and monitoring such rules?

ANSWER:

I have stated that if MLPs were to be taxed as corporations, I would favor grandfathering existing MLPs for a limited period of time. During this period, they would continue to be taxed as partnerships, except that I would suggest that the income generated be classified as portfolio income. After this period, they would be taxed as corporations. With the use of such a "cliff", rather than a phase-in, there should be no complexity in providing transition relief to existing MLPs. In contrast, the current taxation of MLPs poses such difficult problems of conformity and administration that I do not think that the permanent grandfathering of existing MLPs could be justified on the grounds of tax simplicity. Moreover, a permanent grandfathering would provide existing PTLPs with a competitive advantage over all other firms.

3.

QUESTION: Is this another quick-fix temporary solution in light of the current studies on Subchapter C? Should we wait and develop a sound, equitable treatment in regards to the taxation of various ownership structures?

ANSWER:

I believe our current examination of the MLP issue has been rather extensive, and that our conclusions are based on sound analysis. It is also the case that the longer the delay in acting, the more severe would be the resulting transition problem. Based on the recent growth in MLPs, from 25 to 50 new MLPs might be formed by the time the Subchapter C study is expected to be submitted to the Congress.

4.

QUESTION: Won't the repeal of the General Utilities doctrine discourage most of the PTLPs which would have been formed to escape double taxation? Won't those which are created be heavily taxed at formation?

ANSWER:

It is indeed the case that the formation of a liquidation MLP is likely to initially result in a revenue gain, especially with the increase in individual capital gain rates and the repeal of the General Utilities doctrine. For that very reason it is not expected that many liquidation MLPs would continue to be formed, except perhaps in those cases where the liquidating corporation has sufficient net operating losses with which to offset the gains recognized upon the liquidation. At the same time, however, the repeal of the General Utilities doctrine increases the tax burden on assets held by corporations, and therefore increases the incentive for the use of PTLPs by nonliquidating corporations and newly formed businesses.

Chairman RANGEL. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Secretary, the current issue of the Wall Street Journal today quotes an individual saying there are 99 master limited partnerships trading on the major stock exchanges. We have discussed here 127. And I wondered, is there a difference in definition?

Mr. MENTZ. I don't think it is definition. I think we have got some that are in stages of registration that are not yet traded. I think that is probably the difference.

Mr. BROWN. The difference.

Mr. MENTZ. We have a list, Mr. Brown, and of course, I would be glad to provide you with much more information than you would ever want to see on MLPs.

Mr. BROWN. That may apply to many in this room. You never know.

Directing your attention to table 3 on your statement, if I could. The bottom portion talks about treating income as portfolio income. And I guess my question is is that level of revenue on the bottom half already in our current baseline? If I understand it right, our statutes now give you the authority to treat it that way. Are these figures already in our baseline revenue projections?

Mr. MENTZ. Yes, they are.

Mr. BROWN. They are.

Mr. MENTZ. Yes, they are.

Mr. BROWN. So, it's no new revenue.

Mr. MENTZ. That's right.

Mr. BROWN. This is simply a recognition of how much—

Mr. MENTZ. The assumption made in estimating the bill was that Treasury regulations would be issued that would reclassify at least exchange-traded MLP income as portfolio income. So, your question is a good one.

Mr. BROWN. I take it that that process is on track and that you anticipate that will come to pass.

Mr. MENTZ. That process is on track. A final decision has not yet been reached.

Mr. BROWN. The figures in the table up above, "Tax as Corporation," indicates a revenue pickup if those publicly traded partnerships were taxed as a corporation. Is that in addition to the revenue we will gain from the—how does that square with the revenue we are already estimating we would get for treating the income as portfolio income?

Mr. MENTZ. That includes the treatment of income as portfolio income. In other words, the 260 is in the 665.

Mr. BROWN. Okay. Let me see if I understand. The 260—where are we getting that from?

Mr. MENTZ. Well, that's treating—

Mr. BROWN. The 260 over your—

Mr. MENTZ. That's right. All the way over on the right, the fourth line from the bottom.

Mr. BROWN. Oh, I see, okay.

So, if the 260 is in the 665, then the net increase from baseline would be 405?

Mr. MENTZ. That's right.

Mr. BROWN. That's \$405 million. So, the net increase to treat them as corporations would not be 665 over baseline. It would be 405 over baseline.

Mr. MENTZ. That's right. I suppose there is a question as to whether the baseline will change, you know, depending upon whether regulations come out or not.

Mr. BROWN. Page 1, footnote 1, you reference publicly traded partnerships. How are you defining publicly traded? What does that mean? Does that mean on a major exchange?

Mr. MENTZ. That's a tough question. I have in my written testimony, which I omitted to explain, but on the very last—on page 18, you will see that obviously exchange-traded is easy. But when you get to a partnership that is not traded on an organized exchange, it can still be traded either over the counter or a market can be made in it through a brokerage firm or a series of brokerage firms. And drawing the line there is not easy. And I don't have a real simple solution for you.

I think clearly publicly offered limited partnerships—that is going too far. That should not be picked up. The notion is equivalency to a publicly—to a corporation whose shares are publicly traded in some way.

And I think the hard question is what level of market making activity by the investment banking firm that offers the limited partnerships would be enough to put it over the line. I think that is the issue.

Mr. BROWN. Difficult.

Mr. MENTZ. Yes, not an easy issue. That's right.

Mr. BROWN. What definition did you use in putting the table together? Is that just the ones on the public exchanges?

Mr. MENTZ. Yes. You will see in the footnote to the table—

Mr. BROWN. It looks like—it referenced organized exchange.

Mr. MENTZ. Yes.

Mr. BROWN. With the little contact I have had with those exchanges, I'm not sure I would refer to them as organized. [Laughter.]

Mr. MENTZ. The notion was to just pick up exchange-traded. What we were trying to do is show the two extremes: exchange-traded only and other one which is way off the—

Mr. BROWN. When we say exchange-traded, would that include over the counter with the computer market?

Mr. MENTZ. No.

Mr. BROWN. It would only be American, New York and Pacific and the others. So, it would not include, for example, the—

Mr. MENTZ. Oh, it does include over the counter? Sorry. It does include over the counter.

Mr. BROWN. It does include over the counter.

Does it include the activities of Merrill Lynch that would maintain a market?

Mr. MENTZ. No, it doesn't.

Mr. BROWN. How did you work that definition in your assumptions for the table? What counts as over the counter and what counts as—

Mr. MENTZ. Why don't I get back to you with a clear—hopefully clear—explanation of how we got those distinctions?

Mr. BROWN. I think that would be very helpful because obviously if we draft something in this area, Mr. Chairman, we have got to toil with that definition that strikes me as not the easiest to work with.

If I could, Mr. Secretary, let me ask that you give us an indepth breakdown of table 3 with the precise definitions that you used and a followup on the entities. You have given us the number of entities you are looking at now, but not the number of entities that you used for the growth that is shown in the table.

Mr. MENTZ. Okay.

Mr. BROWN. If you've got a breakout on what portion of the income of these entities goes to corporations, I think that would be helpful in understanding. If I understand it right, if you tax the MLPs as corporations, there are payouts or dividends that might go to corporations that would receive different tax treatment than if they went to individuals.

Mr. MENTZ. Yes, that's right.

Mr. BROWN. If we could have that kind of breakout, I think it would be helpful for us to get a better handle on the issue.

Mr. MENTZ. Sure.

Mr. BROWN. I was wondering if you could give us an idea of what you see happening if we do tax MLPs as corporations. I mean how will they respond? Will some become subchapter S? Will some become REITs? Will some quit trading publicly? What are the dynamics there?

Mr. MENTZ. Well, I think that assuming you have a transition rule, which I think you would naturally want to do, clearly the entities that are already in MLP form would stay that way for the duration of their transitional relief. Entities that are presently in corporate form and entities that are—or businesses that are newly created or newly formed, would still have a strong incentive to be in a partnership or flow-through single tax form. So, the economic drive to get to that result will still be the same. But the options will be limited and would be set by you rather than just the creativity of the tax lawyers.

And I think what some of them will do—clearly the natural resources, if you have an exception, the oil and gas folks will still put properties into a vehicle and sell off interest to the public. I think that will still happen. REITs will undoubtedly still continue, and will probably be more of them because real estate won't be able to use the MLP form. And regular, ordinary businesses that are conducting active business affairs, those that can be Subchapter S—of course, the limitation on shareholders there is significant, 35 shareholders, a significant limitation. But those that can get in a Subchapter S, small business, small corporation, will do so. But the vast bulk of corporate America that raises its capital through public offerings will stay in corporate form and life will go on pretty much as it has been before the mid-1980's.

I don't see any down side, any economic dislocation or disruption by doing that.

Mr. BROWN. The problem I was trying to get at—and I don't know how anybody comes up with a table that deals with it, but I'm assuming that these projections that you have given us in table

3 are a projection of what happens to the revenue loss if we don't act.

Mr. MENTZ. Well, no. No, no. This is what happens if you do act. And I don't have a projection for what happens if you don't act.

Mr. BROWN. Well, what I'm wondering about is do the projections in table 3 calculate a portion of the MLPs dropping out to Subchapter S or REITs?

Mr. MENTZ. Yes. There is——

Mr. BROWN. It does.

Mr. MENTZ. That's right. There is a behavioral change if you do act. Some percentage of them that would have been in MLPs will be just limited partnerships not publicly traded. Others will not. That is a behavioral reaction that is in here.

But what I can't give you and it is difficult to get a handle on what the revenue cost will be of inaction which will cause more MLPs.

Mr. BROWN. If it would be possible, if you could include that breakout of those behavior patterns in a layout of your assumptions on the table, I think that would be helpful to us.

Let me ask you the tougher part of this. I mean, at least it is tougher for me.

Mr. MENTZ. I was going to say you are tough enough already.

Mr. BROWN. We are dealing with a unique phenomenon here as I see it because for the first time, at least in more than a half a century, you have got a lower personal rate than a corporate rate. And while I know we traditionally look at it in a two-step comparison, oftentimes for a business purpose you only look at the initial tax depending on what your intention is with regard to the business. You have suggested we ought to look at dealing with this by taxing the MLPs as corporations.

Let me ask you about the alternatives. One of the alternatives looks to me like you might go back and deal with the regulations or perhaps statutorily deal with the question of limited liability. I mean one of our options—isn't it simply to change the way you define qualification for limited liability or not limited liability in the definition of a corporation? Why have you chosen to go at MLPs rather than go back and deal with the fundamental question on the factors that make up a corporation?

Mr. MENTZ. Well, if you made limited liability—at one point there was a proposal to make limited liability a kind of a super factor so that if it was—if you had limited liability, you were going to be classified as an association taxable as a corporation.

That would be a much broader net, and would sweep in many more entities. It would sweep in any limited partnership, you know, 35-man or even smaller. If it had limited liability, it would certainly have, depending upon the proposal, a much greater chance of having a much broader class of entities made taxable as corporations. And frankly, we didn't want to be that aggressive.

Mr. BROWN. I can appreciate that. What I am searching for is some consistent treatment here. And maybe consistency is not to be found. But by attacking MLPs from the point of view of being marketed, free transferability, it seems to me you tax them as corporations for being marketed. But you don't tax the REIT for being marketed, and you don't tax the subchapter S for being marketed

although maybe it is small enough that it gets to be a different question. But it looks to me like what we do is come up with a way of treating MLPs that is fundamentally different than the way we are treating other kinds of associations.

Mr. MENTZ. Well, I recognize that any distinction, any line-drawing, is going to have problems with it. And no everyone will agree on exactly where it should be. We started with the proposition that a large publicly owned and publicly traded corporation conducting an active business should be in the same position whether it happens to be organized as an MLP or organized in the State of Delaware as a corporation.

And I think it hard to argue with that. I think that is pretty basic. And our tax law doesn't do that today. Back in developing our position in 1986, we recommended that Congress take a look at changing that. And once you start there, the question is how do you get there and how far do you go.

And I recognize the lack of total purity of a line that is drawn on whether it is publicly traded or not, but there is a logic to it, and that is that similarly situated entities that have access to the capital markets in the same way ought to be treated the same.

Mr. BROWN. Well, I guess the problem is if an individual's goal is to have an ownership publicly traded and have limited liability and not pay corporate tax, by taxing the MLPs as a corporation, we haven't stopped that. All we have done is put our finger in the dike and it pours over somewhere else because I assume if you want all those aspects you simply go to an REIT or you go to some other entity.

Mr. MENTZ. Well, but an REIT is something that the Congress has expressly sanctioned. And I would think that would be in accordance with your intentions. If you wanted to pass a law that said you can have an MLP under these conditions, and define a bunch of conditions, that would at least be Congress setting out explicitly what its will is. And in my suggestion on natural resources, that is really what that amounts to, and that is what you have done in REITs.

Mr. BROWN. Sure.

Mr. ANDREWS. Mr. Brown?

Mr. BROWN. Let me throw out one more. Well, excuse me. Go ahead.

Mr. ANDREWS. I just wanted to interject one question to be sure I understand now what you are saying on the issue of transferability. You are not suggesting, are you, that the fact that public trading is determinative of corporate characteristics or is significant.

Mr. MENTZ. Well, yes. It is very significant. If you have a limited partnership whose shares are publicly traded, that should be taxed as a corporation because of the publicly traded characteristic of its equity.

Now, you can get there in several different ways. You could amend the regulations except I think we all recognize that that is not a likely way to proceed. It is going to have to be statutory. But I think the statutory change is a change that creates kind of a super factor for publicly traded entities so that whatever the entity is, if its interests are publicly traded, and if we can agree on what publicly traded means, that is classified as an association, taxable

as a corporation. That is the fundamental suggestion made in the testimony.

Mr. ANDREWS. I mean the fact that 98 percent of all corporations are not publicly traded—

Mr. MENTZ. Yes.

Mr. ANDREWS [continuing]. The fact that historically a transferability criteria has not been a significant determination of whether or not an entity is a corporation—

Mr. MENTZ. Well, if you are a corporation, if something is organized as a corporation, it is automatically taxed as a corporation. What we are talking about is an association not organized as a corporation and whether or not it is to be taxed as a corporation.

Mr. ANDREWS. Thank you.

Mr. BROWN. Mr. Chairman, with your permission, I have just one additional question I would like to ask the Secretary to respond to.

One other alternative it seems to me might be considered in this area is to take another look at the rate differentials instead of having the corporate rate higher than the personal rate, which we have I guess moved to with the new tax bill and which is a dramatic change from what we have had in the past. What was your thought in not revisiting those rates and adjusting it so you don't have quite the enthusiasm from a rate point of view to move to MLPs?

Mr. MENTZ. Well, first of all, certainly it would not be the position of the administration to change the fundamental part of tax reform which was the rates. I think those are kind of enshrined in gold as far as the administration is concerned.

But I would call your attention to table 1 which indicates that even before tax reform with the rates going the other way, there still was an incentive to have a business in noncorporate form or in partnership form. No question that—and it isn't so much just the rates. I think the more important element of tax reform is the corporate changes and the individual cuts which, as you know, switched about \$140 billion off of the individual taxpayer onto the corporate taxpayer. It is that shift that makes operating in noncorporate form more desirable. But even before that, my point is that you still had a bias in favor of single tax over double tax.

Mr. BROWN. Well, but to that point, that wasn't—I mean, depending on your assumptions, that isn't necessarily the case, is it? I mean, when you have a significantly higher personal rate than a corporate rate, and your intention is to leave the money in the business and let it accumulate, and you don't plan on selling the ownership of it right away, isn't it a fact that at least with regard to that initial rate that it was more attractive to be a corporation than a partnership?

Mr. MENTZ. Well, that is right. And that is why we have accumulated earnings tax rules and personal holding company rules that we may be able to eliminate or drastically simplify under the current rate structure. So, you know, there are countervailing considerations. But yes, your point is right.

Mr. BROWN. I guess from a point of view, my hope is that you might want to look at that rate question at least as one of your alternatives as you deal with this.

I yield back, Mr. Chairman.

Chairman RANGEL. Thank you, Secretary Mentz. You had indicated earlier that your views might be different if you were in the private sector. How much time do we have to work—[Laughter.]

Mr. MENTZ. I didn't say my views would be different. I said I would be out there forming MLPs.

Chairman RANGEL. Well, you are convinced that the position that you presented today is the position of the administration and that we can depend on that position. Right?

Mr. MENTZ. The position I have presented today is the position of the Treasury Department. It is the same position that the administration had in June of 1986, and while there is some further review going on in the administration, I am speaking for Treasury.

Chairman RANGEL. Let me thank you for your presentation and your willingness to entertain questions which members and perhaps staff may be giving to you. And since some of your predecessors have different views, we may even forward some of their questions to you.

Mr. MENTZ. It is always a pleasure, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Secretary.

The next panel is from the American Bar Association, a representative, the chairman of the section of taxation, John B. Jones; the chairman of the tax division of the American Institute of Certified Public Accountants, Herbert Lerner; and the chairman of the tax section of the New York State Bar Association, Don Schapiro.

Chairman RANGEL. Is Mr. Lerner here? Oh, good.

On behalf of the full committee, I thank you for sharing your views with us on this complex piece of legislation. As I pointed out earlier, in order to give the members an opportunity to take advantage of your expertise, we're going to be forced to restrict your oral testimony to 5 minutes; but, without objection of the subcommittee members, the full text of your testimony will be entered into the record.

Maybe we'll proceed with the American Bar, and take the testimony of Mr. Jones.

STATEMENT OF JOHN B. JONES, JR., CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY STANLEY BLEND, CHAIRMAN, COMMITTEE ON PARTNERSHIPS

Mr. JONES. Thank you very much, Mr. Chairman. I'm accompanied today by Stanley Blend, who's chair of our committee on partnerships, and if technical questions are involved, we may want to call on him.

I believe it will not be difficult to comply with your suggested time limits, because I think that the preceding discussion has illuminated the issues very well.

We agree with the issues as delineated by Treasury. Unlike Secretary Mentz, I think that we do have a clear answer as to the question of whether you should act now or wait. Our view is that you should wait, and act on any question about master limited partnerships in the context of a broader study.

It is true that the deal of *General Utilities*, the new corporate tax rate above the individual rate, they do put pressure on corporations; however, I'm sure it's not forgotten that the same 1986 act

included a direction to Treasury to submit a study on subchapter C, which is now scheduled to come in at the first of next year.

Earlier this year, in April, the section of taxation of the American Bar Association, along with our colleagues from the New York State bar, had an invitational conference on subchapter C attended by 150 or so leading people from the bar, from the teaching professions, and from government—both in administration and on the Hill—to consider, in depth, what changes should be made in subchapter C in light of the 1986 act.

There was a recurring theme that sounded through these proceedings, from a variety of learned speakers, mainly saying that the basic question that must be decided as we proceed in this area is what businesses we wish to subject to two taxes, that is: tax at the business level where the income is earned, and a tax on the distribution to the shareholders when it's paid out.

We've had a number of—that's a long-time problem. Subchapter C was introduced to alleviate some of the concerns. MLP's put new pressure on that distinction, but we think that it would be wrong to rush to judgment on the MLP's without considering it in the light of the subchapter C revision.

There is also outstanding for consideration a study by the American Law Institute on subchapter K relating to partnerships, and obviously the resolution of these problems here has a lot to do with partnerships, as well as subchapter C.

So we repeat again that any change which is made effecting master limited partnerships should be made as part of one of these two reviews.

I was encouraged today—I believe I correctly heard Secretary Mentz' statement that the Treasury no longer supports the 35 partner limit as the limit. As our testimony says, we think that's very inappropriate. We do think that whatever the difficulties in definition may be, that more satisfactory answer is going to be done in terms of determining whether a master limited partnership is publicly traded. After all, that is one of the key characteristics which is supposed to differentiate partnerships and corporations, and we think any final solution should go on that line.

And just finally, if we are asking for delay we think that there are obstacles in the present law which hinder the growth of master limited partnerships, and we do not find that all bad. We think that the Internal Revenue Service has every right to insist on the requirements of partnership law, but they shouldn't bend them to make master limited partnerships easier to handle. They shouldn't make new rules, and they shouldn't bend the old ones. Let's enforce the law. The growth is not so rapid that we can't wait for a reasoned decision on master limited partnerships, and we would urge this committee to do that.

[The prepared statement of Mr. Jones follows:]

HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HEARINGS ON MASTER LIMITED PARTNERSHIPS

STATEMENT OF JOHN B. JONES, JR.
SUBMITTED ON BEHALF OF THE
AMERICAN BAR ASSOCIATION

JUNE 30, 1987

Mr. Chairman and Members of the Subcommittee:

I am John B. Jones, Jr., Chair of the Section of Taxation of the American Bar Association. I appear here today to present testimony on behalf of the American Bar Association in support of the position that Master Limited Partnerships which meet the requirements of the Uniform Limited Partnership Act should continue to be taxed as partnerships under the Internal Revenue Code.

The Tax Reform Act of 1986 was the first tax legislation in thirty years to attempt a comprehensive revision of the Internal Revenue Code on a principled basis. While the revision did not go as far as some had hoped, the Act was in large part free of piecemeal, ad hoc corrections to perceived deficiencies. In the long run, narrowly focused tax corrections, however well intentioned, may do more harm than good to the income tax system. Master Limited Partnerships may be more a symptom of underlying problems than the source of problems.

SUBCHAPTER C

The 1986 Act did not address completely the area of subchapter C, that part of the Code dealing with corporate distributions, reorganizations, and the like. Congress directed Treasury to report back to the Congress by January 1988 on further steps which should be taken in light of the repeal of the General Utilities doctrine.

In April of this year, the ABA Section of Taxation, along with the Tax Section of the New York State Bar Association, conducted an Invitational Conference to consider the changes in subchapter C made necessary or desirable by the 1986 Act. The proceedings will soon be published in book form. We trust they will prove useful to Congress, as well as Treasury, in implementing the statutory mandate. A recurring theme at the Conference was that Congress must decide, as a matter of policy, what category of businesses it wishes to subject to double tax -- that is, a tax to the business entity and then taxation of the remaining income when distributed to the investors.

Over the years, the number and type of organizations not subject to two-level tax has grown considerably. Many enterprises, particularly those with significant losses or other deductions, have elected to follow the partnership or limited-partnership route, even though this requires immediate tax to the investor on earnings, whether or not distributed. Other businesses have required or preferred the limited liability, transferability of ownership, or financing potential of corporate form. Subchapter S, first introduced in 1958, allowed certain corporations to elect to be taxed as partnerships. Over time the limit on number of shareholders has grown from 10 to 35, and there has been an easing of other restrictions. There is now no clear rationale for the distinctions between businesses taxed once and businesses taxed twice. For example, 35 shareholders can control a very big business, much bigger than that of a small manufacturer who finds it desirable to sell stock to 50 of his employees.

EFFECT OF 1986 ACT

These definitional problems have been with us for a long time. They have become much more acute under the 1986 Act. The repeal of General Utilities makes the conventional corporation less attractive. The setting of a maximum corporate tax rate 6 percent higher than the maximum individual rate puts a premium on avoiding corporate tax. The growth of Master Limited Partnerships is merely one current response to these pressures. Unless we set a clear guideline for the circumstances in which two taxes are required, there will be new varieties of one-tax business enterprises springing up to take the place of Master Limited Partnerships no matter how much they are restricted.

It is our view that the subject of Master Limited Partnerships should not be addressed separately. A restudy of subchapter C should offer a reasoned choice among distinctions based on the whole range of business enterprises. A happy result of such consideration could be further inquiry into integration of corporate and individual tax which would render Master Limited Partnerships moot.

CHANGES IN PARTNERSHIP TAXATION

Another broad area to be addressed by Congress relates to the details of the manner in which partnerships are taxed. Passing through tax consequences to individual partners is inherently complicated and made much more difficult by the transfer of partnership interests. Taxpayers are constantly on the lookout for ways to shift income one way and deductions and credits another, in order to minimize tax liability. The American Law Institute made a comprehensive review of the provisions of subchapter K in 1982 and made several suggestions for improvement, some of which have been adopted, a few in the 1986 Act. In general, the American Bar Association supports these proposals. If adopted, they would limit the possibility for abuse by Master Limited Partnerships.

It was in the context of this ALI study that the American Bar Association, on the recommendation of the Section of Taxation, adopted its position that organizations qualifying as partnerships or limited partnerships under State law should be taxed as partnerships under the Internal Revenue Code. On this point, the Tax Section, after debate, differed with the ALI, which had recommended that publicly-traded partnerships be taxed as corporations. It was felt that the complexity and uncertainty introduced by alternative systems of partnership taxation were not justified by the perceived shortcomings of the existing straightforward method of classification.

IF, CONTRARY TO OUR POSITION, MLPs ARE SEPARATELY ADDRESSED,
THE FOCUS SHOULD BE ON PUBLIC-TRADING
RATHER THAN NUMBER OF PARTNERS

Admittedly, the situation is a dynamic one. Amendments in the 1986 Tax Act have put the corporate rate higher than the individual rate, eliminated General Utilities, and stiffened the minimum tax, making corporations significantly more onerous from the tax point of view. Also, the creative minds in corporate finance have apparently pushed the partnership concept further than many believed possible five years ago. In some cases, steady income producing assets are being removed from corporate solution, leaving more break-even assets behind. Thus, in the context of a broader approach to the double tax problem, many of our tax lawyers would be willing to consider some limitations on use of the partnership form.

While the ABA has no position, it has seemed to me and other tax lawyers that, if a limitation were to be considered, the American Law Institute proposal which would draw the line at partnerships with interests traded on an established security market is much to be preferred to the Treasury's 1984 35-shareholder limit. The exact number of shareholders has little to do with the size or nature of the enterprise, whereas public trading focuses on one of the historic distinctions between partnerships and corporations. An enterprise, once qualified on a number basis, may face a disqualifying involuntary increase in shareholders for reasons unrelated to the business. Moreover, if we are to have a double tax on corporate earnings, a publicly-traded test would put most major business enterprises on the same footing without catching up smaller corporations that for one reason or another have a lot of small stockholders.

THE IRS CAN CONTROL GROWTH OF MLPs PENDING FINAL DECISION

Concern has been expressed that unless action is taken at this time, there will be a wild rush to disincorporate. The repeal of General Utilities puts a sizable tax block in the way of existing businesses wishing to switch. There are practical obstacles to others, since large publicly-traded enterprises do not fit neatly in the partnership mode. We believe the Internal Revenue Service could cause promoters of Master Limited Partnerships to reflect on these difficulties by announcing an intention not to waive partnership requirements. The Service is aware of these problems and can do much to help the situation pending legislative decisions on broader reform.

For example, the Internal Revenue Code often makes partnership taxation work by intricate non-uniform adjustments to basis. The marketplace, on the other hand, requires that all traded units be of equal value. Various devices have been tried to resolve these goals. Another item. Market-traded securities are often held in street names but partnership taxation assumes that the identity of partners is known to the partnership. Until further basic decisions are made, there is no reason for the Internal Revenue Service to fashion new rules, or bend old ones, to make it easier for Master Limited Partnerships to meet traditional partnership requirements.

It has also been suggested that effective tax audits are costly and impractical if adjustments have to be carried out on a large number of individual returns. The partnership audit provisions of TEFRA were addressed to this problem, which is by no means confined to Master Limited Partnerships. From its experience in dealing with tax shelter partnerships, the Service has learned a great deal about dealing with large partnerships. If present law is inadequate, it may be that the right place to legislate is to expand on the partnership

audit provisions rather than limit or outlaw Master Limited Partnerships.

CONCLUSION

We commend the Subcommittee for addressing this important topic. Ideas developed here will make a valuable contribution to improvement in taxation of business entities. We urge, however, that no legislative action be taken with regard to Master Limited Partnerships except as part of a broader revision of the Code.

Chairman RANGEL. Thank you, Mr. Jones.
Mr. Lerner?

STATEMENT OF HERBERT J. LERNER, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LERNER. Thank you, Mr. Chairman.

I'm Herbert J. Lerner, testifying today as chairman of the Federal taxation executive committee of the American Institute of CPA's. We represent over 240,000 CPA's who work with tax matters on a daily basis, including complex partnership issues.

First we'd like to commend this subcommittee for addressing this issue, which obviously deserves considerable attention at this time. We submitted rather detailed comments, which I'll just summarize briefly here this morning.

We would agree that, without question, the increase in MLP's over the past number of years, is attributable to a number of tax oriented factors. The 1986 act was probably the single largest impetus in that area, specifically through the repeal of *General Utilities*, and the reduction of the rates in 1988 so that the individual rate is less than the top corporate rate.

As a consequence, the typical investor in an MLP appears, as a general matter, to be an individual, as opposed to a corporate or an institutional investor.

The MLP affords the individual investor the opportunity to participate in certain markets, such as, for example, commercial real property ownership, where he might otherwise be precluded due to an individual's lack of sufficient capital. And there may be some natural limitations on the growth and use of MLP's.

In an MLP the investor pays a current Federal income tax on respective shares of the annual earnings of the partnership. In the case of a corporate shareholder, of course, those earnings are not taxed at the shareholder level until distributed. So an MLP experiences tremendous pressure to make cash distributions to its partners on a current basis in an amount sufficient, not only to help the investor pay the resulting tax liability on the share of MLP income, but also to yield the investor a net aftertax cash return.

Some of Treasury's concern with respect to MLP is motivated, in part, by belief that some of the technical provisions of subchapter K, dealing with partnerships, don't work as well in the instance of MLP's. One concern is the level of compliance at the individual investor level, that is: even if the entity reports all items of income or loss to the service, is each partner reporting and paying tax on the distributive share of that income? Clearly I think that Congress has previously enacted legislation that required appropriate reporting to ensure investor compliance, and it has seen fit to establish penalties for any failure to satisfy those reporting obligations, and there are some pending provisions in technical corrections that bear on that as well.

To the extent that MLP's, or other partnerships, do not achieve complete compliance with every aspect of subchapter K, there is some reason for concern; however, this lack of full compliance should not, in and of itself, justify changing the classification of

MLP's. Our written submission addresses a number of those technical issues more fully.

Proponents of MLP taxation argue that MLP units in substance aren't any different than corporate stock; however, I think there are two significant distinguishing factors. First, the capital markets tend to evaluate the two evidences of ownership in very different ways. Stock generally trades on a basis of a multiple of anticipated earnings, the price-earnings ratio; MLP units are often valued as a function of anticipated cash distributions.

A second distinguishing feature is the current inclusion in income, but, of course, that is a tax-driven factor.

These relatively significant differences, however, between MLP units and stock shares do exist, regardless of how the units are promoted in the market place.

The AICPA tax division believes that any proposal to change partnership classification, as it relates to MLP, should not depend simply on the number of partners or the manner in which partnership interests are sold or exchanged; rather, we believe that the partnership classification may continue to be appropriate for MLP's.

We believe that the treatment of MLP's shouldn't be altered before there's due consideration of the other issues that bear on the integration of our tax system, and that those issues should be reviewed in an orderly and comprehensive fashion. MLP is simply one of those issues that happens to be more visible at this time.

We appreciate the opportunity to participate in these hearings, and welcome the opportunity to respond to your questions.

[The prepared statement of Mr. Lerner follows.]

STATEMENT OF HERBERT J. LERNER
CHAIRMAN OF THE
FEDERAL TAXATION EXECUTIVE COMMITTEE
OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

I am Herbert J. Lerner, testifying today as Chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. The AICPA represents over 240,000 CPAs, many of whom work on a daily basis with the partnership issues of the type we are here to discuss.

We commend the Subcommittee on Select Revenue Measures and Chairman Rangel for initiating a discussion on a topic which has become a subject of considerable interest to the Treasury Department and tax practitioners. The use of pass-through entities, such as partnerships, has grown increasingly in recent years and is today employed by both large and small businesses.

As a preliminary matter, it is important to differentiate between a master limited partnership (MLP) and other forms of partnerships. For purposes of our testimony, any reference to a master limited partnership is intended to encompass any partnership which is registered with the Securities and Exchange Commission and in which the units representing beneficial ownership are regularly traded on a recognized securities exchange, such as the New York or American Stock Exchanges. This is to be distinguished from a publicly registered partnership (i.e., a partnership required to file a registration statement with the Securities and Exchange Commission, but whose units are not regularly traded on a recognized securities exchange) and nonpublic partnerships (i.e., those which are neither registered nor publicly traded). In considering any Federal tax legislation which may be proposed to affect MLPs, we strongly suggest that due consideration be given to any corresponding effects upon investors in publicly-registered and nonpublic partnerships.

HISTORY OF THE PARTNERSHIP CLASSIFICATION REGULATIONS

Form of business: While MLPs generally trace their origin back only to 1981, the partnership form of organization antedates the corporation. Indeed, the Internal Revenue Code and its predecessors have long given taxpayers a choice in structuring their businesses. Owners may choose generally to operate their businesses in any one of many forms, including proprietorships, partnerships, or corporations (including S corporations). Additionally, certain businesses may choose to operate under special rules adopted by the Congress over the years to encourage specified activities, such as Real Estate Investment Trusts (REITs), Regulated Investment Companies, (RICs), Small Business Investment Companies (SBICs), and, most recently, Real Estate Mortgage Investment Conduits (REMICS). Because taxpayers may structure their affairs in a way that minimizes their overall tax liabilities and provides a more desirable operational format, the distinction between such entities is critical for purposes of overall business and tax planning. As the distinctions between these entities have evolved under state law, court decisions and Treasury pronouncements, one principle has remained constant: there is a need for a clear line to be drawn between business forms so that the Treasury can adequately and efficiently administer the rules and taxpayers can act with the necessary degree of certainty. In recent years, a great deal of attention has been focused by the Congress and the Treasury on the use of pass-through entities, such as partnerships, as tax-oriented investment vehicles. It is not without irony that the expanded use of the partnership form was made possible in large part by the Service's desire in the so-called Kintner regulations to favor partnership classification over the corporate form in order to curtail the growth of professional service corporations.

The Kintner regulations: Under the present classification regulations, an unincorporated entity is treated as a partnership for Federal income tax purposes if it has at least two of four partnership characteristics: limited life; unlimited liability; lack of centralized management; and an absence of interests which are freely transferable. These classification regulations have been in place for almost 20 years and have withstood the regulatory and judicial test of time.

Some commentators have suggested that one factor in the existing Kintner regulations should weigh more heavily than any other in determining the income tax classification of an entity. For example, the suggestion has been advanced that an entity should be treated for Federal income tax purposes as a corporation unless at least one member has unlimited liability for the debts of the organization. The Treasury attempted to adopt such a standard several years ago to deal with the so-called Wyoming Limited Liability Act entity. In those proposed regulations, the Treasury elevated the factor of limited liability and held that an unincorporated organization automatically would be treated as a corporation unless at least one member had this full unlimited liability. Those regulations were withdrawn, in part, because of adverse comments concerning the possible impact of the proposal on the proper tax classification of foreign entities. The point to be noted is that in the past when administrative efforts attempted a true resemblance test or elevated one factor over the three others, the Kintner regulations have been retained as the more reliable approach to the classification question.

PRIOR TREASURY PARTNERSHIP CONCERNS AND RESPONSES

Extensive legislative action by the Congress: In reaction to the growth of tax shelters prior to the enactment of the Tax Reform Act of 1986 (the "1986 Act"), the Treasury requested and the Congress responded over a period of years by enacting or revising numerous provisions of the Internal Revenue Code. Beginning with the passage of the investment interest expense limitations in the Tax Reform Act of 1969, the pace quickened with the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984 (the "1984 Act") and, most recently, and perhaps most comprehensively, the 1986 Act. The major anti-tax shelter provisions enacted by the Congress include: the at-risk limitations with respect to tax losses and credits; the passive activity loss limitations; and the partnerships level audit rules. In addition, the Congress has limited the options a partnership has in electing its method of accounting (I.R.C. §448), taxable year (I.R.C. §706(b)), and its ability to allocate items of income, gain, loss, deduction and credit among the partners (I.R.C. §§704(b), (c), (d) and 706(d)). Significant and numerous other amendments to the Internal Revenue Code have been adopted with more specific targets, including sections 189 and 263A (dealing with construction period interest and taxes), section 461(i) (certain prepaid items), section 464 (certain farming expenses), section 467 (the treatment of uneven rental payments), and section 709 (partnership organization and syndication expenses).

An additional and important point is that the partnership tax rules were extensively revised by the Congress in 1984. The professed objective of the provisions of the 1984 Act was to conform the partnership rules to the more modern use of the vehicle. It is noteworthy that the Congress did not choose to change the Kintner regulations at that time and, for the reasons stated below, we do not believe that it is appropriate to change the classification at this time.

In addition to the substantive changes made to the laws governing the taxation of partners and partnerships, the Congress has instituted a number of comprehensive administrative and compliance reforms. IRS examinations for partnership taxable years generally ending after 1982 are conducted at the entity level, greatly enhancing the potential audit efficiency and effectiveness of the IRS. Similarly, extensive reporting requirements and penalty provisions enacted since 1981 should improve the level of partner reporting of partnership items and resulting compliance with the tax laws.

It should be noted, however, that because of the volume and frequency of legislative change, the Treasury has been unable to issue the regulations necessary to implement all of the statutory amendments and modifications in many of the areas affecting the taxation of partners and partnerships.

Judicial activity: Separate and apart from this significant legislative effort, the courts (principally the Tax Court) have begun to reduce the extensive backlog docket of tax shelter cases. In instances where the court believes that the underlying transaction was uneconomic (separate and apart from the tax benefits) and/or a sham, it has had little difficulty finding against the taxpayers, not on the basis of recent legislation, but rather by use of general tax principles, such as the lack of economic reality of the transaction in question.

Summary: Any supposed historical bias of the Kintner regulations to encourage tax shelters should no longer be of concern to the Congress, simply because prior legislative efforts have substantially removed the impetus for tax shelter oriented limited partnerships.

SHOULD AN ALTERNATIVE LINE BE DRAWN?

In its report on tax simplification and reform dated November 1984, the Treasury proposed that all limited partnerships with more than 35 limited partners should be treated as corporations for Federal income tax purposes. The number 35 apparently was chosen to conform to the number of permitted shareholders in an S corporation. While such a bright line test has the benefit of absolute certainty, the question is at what point the line should be drawn. Should it be 35 limited partners? 100? 1000? Publicly registered partnerships traditionally have had several thousand partners. The mere fact of size has not appeared to hamper the Internal Revenue Service in its examination function since enactment of the uniform partnership audit rules. Indeed, the Treasury in testimony before the Senate Finance Committee in 1983 (the "1983 testimony") stated that master limited partnerships, because of the reporting requirements imposed upon them and the public scrutiny they receive, are less likely to engage in abusive activities than partnerships with fewer partners.

Should the fact that the interests are publicly traded change the result? If so, that would appear to penalize the creation of an efficient market system where all investors, large and small, have full knowledge of relevant information. In fact, Treasury in the 1983 testimony stated that marketability of ownership interests should not determine an entity's tax treatment.

Should one factor override all the other factors in determining the classification of an entity as a partnership versus a corporation? History teaches us that such an approach may prove unworkable. Moreover, the numerous recent refinements of partnership (and partner) taxation have substantially eliminated the potential for abuse of the partnership form.

GROWTH OF MLPs

Partnership taxation in general: Inasmuch as a partnership itself is not subject to Federal income tax, but rather the partners are directly taxed on their distributive shares of partnership income regardless of whether or not it is currently distributed, the effective tax rate applied to income from a partnership depends on the individual brackets of its partners. Tax losses and deductions similarly are passed through to the partners and may generally offset such partner's income from other sources. However, the partner's ability to use these losses and deductions is subject to extensive limitations, including the partner's basis in his partnership interest, the "at-risk" rules and the new, and highly significant, passive activity rules.

Use of the partnership form traditionally has allowed the partners to allocate tax burdens and benefits among themselves in any manner agreed to, but this flexibility is not without its restrictions. If the allocations of income or loss made by the partnership agreement do not correspond to the underlying economic benefit or burden, the partnership's items of income, gain, loss or deduction are then allocated among the partners in accordance with their underlying economic agreement.

The Congress previously has responded to attempts by partners to shift among themselves partnership income or loss, as well as gain recognized by a partnership on the sale or exchange of assets contributed to it. Sections 704 and 706 virtually preclude the allocation of partnership items to a partner prior to his admission or subsequent to his withdrawal. Additionally, any "built-in" gain or loss on assets contributed to a partnership must be allocated to the contributor when the partnership disposes of the asset. Thus, the law precludes a shifting of inherent gain to a partner other than the contributor.

In other words, Congressional action and recent Treasury regulations make it practically impossible to ignore partnership economics when determining the way in which tax attributes should be shared by the partners. The tax consequences, quite simply, now follow the entity's economics.

Distinguish from taxation of corporations: A corporation, in contrast, is a separate and distinct taxable entity. Except in the case of an S corporation, corporate income and corporate losses are not passed through to the entity's shareholders. Rather, income is subject to tax at the corporate level. Similarly, net operating losses remain with the entity, where they may be carried over or back (subject to restrictions), and thus may offset prior or future taxable income. Distributions of money or other property are taxable to shareholders, but generally only when made and only to the extent of the corporation's earnings and profits. If the distributing corporation lacks earnings and profits, the distributions first act as a tax-free return of capital to the extent of the shareholder's basis in his stock. Distributions in excess of basis are taxed generally as capital gains. Thus, the two-tier corporate tax (often called "double taxation") is not currently applicable if the corporation makes no distributions (subject to the potential imposition of certain "penalty" taxes) or if it makes distributions but lacks earnings and profits.

While shareholders of certain corporations can elect to be taxed as a pass-through entity in a manner similar to a partner in a partnership, it should be noted that the S corporation rules are not identical to those of a partnership (in spite of the Subchapter S Revision Act of 1982). Thus, technical differences in the treatment of S corporation shareholders and partners continue to exist. A principal difference is the relative lack of flexibility an S corporation has in allocating items of income, gain, loss or deduction among its shareholders vis-a-vis the partners in a partnership, as well as restrictions on the identity and number of S corporation shareholders. (Of course, both S corporation shareholders and limited partners have limited liability for entity debts.)

MLP growth and limitations: The use of MLPs as a business form has certainly grown in recent years. It appears that some of the increased interest in MLPs has been generated by the changes made in the 1986 Act, specifically the repeal of the General Utilities doctrine and the reduction in 1988 of the top individual rate bracket (28 percent) to a level that is lower than the top corporate rate bracket (34 percent). More importantly, some of the current interest in MLPs arises from business considerations related to specific industries (e.g., real estate and oil and gas), as opposed solely to income tax factors.

The typical buyer in an MLP appears, in general, to be an individual, as opposed to a corporate or institutional investor. The MLP thus affords the individual investor the opportunity to participate in many markets, such as commercial real property ownership, where he might otherwise be precluded due to lack of sufficient capital. While alternative vehicles are available, such as REITs, they lack the flexibility of the partnership form. Additionally, REITs lack the ability to actively manage their investments, thus precluding the REIT's shareholders from sharing in any appreciation attributable to direct managerial and operational efficiencies. Furthermore, the MLP format is not limited solely to the real estate business, a severe constraint imposed upon REITs.

It should also be noted that there may be natural limitations on the use of an MLP. In an MLP, the investors pay current Federal income tax on their respective shares of the annual earnings of the partnership. In the case of a corporate shareholder, however, no tax is imposed at the investor's level until the corporation distributes earnings to shareholders in the form of dividends. Thus, an MLP experiences tremendous pressure to make cash distributions to its partners on a current basis in an amount sufficient not only to help the investor pay the resulting tax liability on his share of MLP income but also to yield the investor a net after-tax cash return. The current investment climate is such that MLPs are generally priced by the capital markets on a multiple of cash flow, rather than the traditional price/earnings ratio used to evaluate corporate stock. Thus, MLPs may not be appropriate for many corporate activities, especially those that need to retain earnings for growth or expansion. MLPs appear most appropriate for businesses with a fixed pool of investments that are self-liquidating or activities that have an established cash flow stream. These businesses encompass activities such as investments in real estate or oil and gas properties, or a discrete, established line of business in which the product or service generates a predictable stream of cash income and has low reinvestment requirements.

Revenue impact: A concern of the Congress and Treasury may be that the MLP form will result in a loss of anticipated tax revenues -- that master limited partnerships will exacerbate an erosion of the corporate tax base. Indeed, on its face, such a concern seems warranted. This argument is intuitively sensible. There are, however, a number of factors which may mitigate such revenue loss, including the following:

- The repeal of the General Utilities doctrine, so that formation of one form of a "roll out" MLP generally results in a taxable event of relatively substantial magnitude. (In a "roll out" MLP, generally a corporation that wishes to distribute a line of business to its shareholders will contribute the business to a partnership in exchange for partnership units and then distribute a portion of the units to the shareholders as a dividend. The distributing corporation generally recognizes taxable gain under section 311(d), while the shareholders generally recognize dividend income to the extent of corporate earnings and profits. A second form of roll out MLP generally does not trigger taxable gain upon creation. However, the contributing corporation continues to hold its investment, so that the corporate level tax is preserved, albeit deferred.)
- The use of leverage by corporations to generate an interest expense deduction arguably acts to reduce or eliminate taxable income at the corporate level. As several commentators have noted, a corporation through the prudent use of debt may reduce or eliminate taxable income. If the creditor is a tax-exempt entity (e.g., a pension fund), not only is the interest ~~expenses~~ deductible by the corporate borrower, but the interest income forever escapes taxation. On the other hand, because an MLP must focus on the current distribution of cash to its partners, the MLP generally would be less likely to assume a fixed cash outflow, such as debt service.
- The profile of shareholders of the typical publicly held corporation versus the MLP investors appears to be significantly different. As indicated above, most MLP interests appear to be held by U.S. individuals. Thus, at least one level of taxation results. Conversely, a portion of America's corporate stock is owned either by tax-exempt investors, such as pension funds, or other corporations. A corporation's income is fully subject to both levels of taxation only if the corporation is

profitable, it pays dividends and the shareholder recipient itself is a tax paying entity. Moreover, if the shareholder is a domestic corporation the shareholder level tax in 1988 cannot exceed a rate of 6.8 percent.

APPLICATION OF PARTNERSHIP RULES TO MLPs

Partnership examinations: Perhaps, Treasury's concern with master limited partnerships is motivated, in part, by a belief that certain of the technical provisions of Subchapter K do not work in the instance of MLPs. Certainly, an MLP, at the entity level, experiences higher tax compliance costs than a corporation of similar size. This arises naturally as a consequence of the taxation of the MLP's income at the partner level. However, under the partnership level audit rules, the IRS examines an MLP at the entity level and, by dealing with the tax matters partner, makes adjustments to the partnership's taxable income or loss. These adjustments, in general, are binding on the individual investors. Therefore, the Treasury Department's concern cannot be that an MLP escapes IRS audit and scrutiny.

A separate concern is the level of compliance at the individual investor level. That is, even if the entity properly reports all items of income or loss to the IRS, is each partner reporting (and paying tax) on his distributive share of that income? Clearly, the Congress has previously enacted legislation that requires appropriate reporting to assure investor compliance and it has seen fit to establish penalties for any failure to satisfy these reporting obligations.

In spite of the computer reporting programs currently in use by MLPs, there appears to be no reporting system that is entirely consistent with all provisions of the Internal Revenue Code, taking into account daily changes in interests. Indeed, thus far it has not proven possible to assure full partner level accuracy. Any deficiency in compliance at the investor level, however, may be a technical problem properly the subject of administrative regulation rather than corrective legislation.

We understand that some members of the Congress may wish to support a legislative change to impose a withholding obligation at the partnership level on distributions to the MLP's partners (other than those which are tax exempt). Although we take no position at this time in support of such a proposal, if it is to apply, we believe the amount subject to withholding should be premised upon the income element included in the distribution, rather than the gross amount distributed. (For example, if an MLP makes a quarterly distribution early in the second quarter of \$2.00 per unit, but the MLP's income for the first quarter is only \$1.00 per unit, any withholding should be based upon the proportionate amount of first quarter income, rather than the gross distribution.) This partnership level withholding would then be claimed as a credit by the partners on their respective income tax returns.

The technical rules in an MLP context: With respect to the taxation of partners in a master limited partnership, the Treasury has expressed concern as to the level of technical compliance achieved by partners of an MLP. These technical issues primarily include the special allocation provisions of section 704(b); the existence of possible retroactive allocations (in violation of section 706); possible constructive termination of the partnership (under section 706); compliance with the rules governing contributions of appreciated or depreciated property (in accordance with section 704(c)); and the ability of an MLP to properly make the special basis adjustments allowed partnerships (Sections 734(b), 743(b), 754 and 755).

First, we share Treasury's concern that an MLP's taxable income be properly reported. Over the past several years, a few firms have developed tax accounting and reporting systems which are designed to allocate to each partner his share of partnership items and to facilitate the reporting of those items to the appropriate partners

and to the IRS. In general, these tax accounting systems make certain simplifying assumptions in methods of allocation. For example, while the MLP units may trade daily at varying offer and bid prices, the partnership may admit all purchasers for a given month as of a single date and assume that all purchases and sales were made at the lowest bid or closing price during that given period. As a result, the allocations made by the MLP may not satisfy the literal language of the statute. Nonetheless, all of the partnership income is allocated among the partners.

If the Service believes the allocations of income made by an MLP are not within the well-established bounds of the Code, the IRS, under its existing audit powers, is free to perform an examination under the uniform partnership audit rules and propose whatever adjustments it deems necessary. As a practical matter, if indeed all partnership items (income, deductions, gain, loss and credits) are reported, any resulting adjustment will be to simply reallocate these items among the partners. These reallocations are likely to have only nominal impact on any one partner and only nominal impact on the Federal revenue (perhaps even favorably).

Second, with respect to a specific tax accounting issue, an MLP may utilize a simpler tax accounting alternative afforded by the Code than a nonpublic partnership. For example, the partnership allocation regulations allow items of income, deduction, gain, loss or credit to be specially allocated among the partners in a manner not fully proportionate with their stated interests in the partnership, provided that the allocations satisfy the complex test of "substantial economic effect." Many nonpublic partnerships make special allocations of partnership items where supportable under the regulations to maximize potential tax advantages to the partners. On the other hand, most MLPs do not make such disproportionate special allocations. Rather, they simply allocate items of income, deduction, gain or loss to each partner in accordance with the partner's stated interest in the partnership. In short, because of their size, MLPs will adopt the most administrable allocation method in order to avoid the complexities inherent in special allocations.

Certain areas, such as contributions of appreciated property and the technical termination of a partnership (if 50 percent or more of a partnership's interests in capital and profits are sold or exchanged within a 12-month period) create administrative problems for MLPs. However, the technical nature of these problems are the same for all partnerships, whether publicly traded, publicly registered or nonpublic. Unlike many other partnerships, MLPs and their tax advisers are aware of these issues and generally have adopted procedures to monitor their compliance. However, there is no absolute assurance that technical compliance will always occur.

In summary, to the extent that MLPs or other partnerships do not achieve complete compliance with every requirement of the law, regulations and administrative pronouncements governing Subchapter K, there is some reason for concern. However, this lack of full compliance should not, in and of itself, justify changing the tax classification of MLPs. Rather, we would hope that the Committee would work with Treasury to reduce present complexities for all partnerships. Further, we hope that minor compliance shortfalls, particularly those that result in minor misallocations among partners rather than underreporting of income, would not be given undue significance.

Imposition of an entity level tax: Some opponents of the pass-through nature of MLPs advance three primary arguments for the imposition of a corporate level tax on the entity. First, the allocations of income or loss made by an MLP fail to satisfy the technical rules of Subchapter K. As noted above, this problem appears to be one of noncompliance with hypertechnical rules, rather than one which signifies potential abuse.

Secondly, an MLP by definition avoids entity level taxation and thus is a form of "self-help" tax integration. Thus, they fear erosion of the corporate tax base. However, the investor mix of corporate shareholders versus partnership unitholders, the effective use of corporate leverage, the effects of tax exempt entities as owners, and other factors may mitigate in full or in part the revenue impact of a lack of an entity level tax on MLPs. Further, we believe that a comprehensive study of the concept of integration of our system of income taxation is still needed. Our 1976 Statement of Tax Policy, Elimination of the Double Tax on Dividends, may be helpful in analyzing the integration issue. The current discussion of MLP reclassification should not cause the Treasury to stop moving ahead with a broader study of integration.

Finally, proponents of MLP taxation argue that master limited partnership units in substance are traded like corporate stock, sold like corporate stock and promoted by brokers like corporate stock. Therefore, MLPs should be taxed like the corporations that issue stock. Indeed, the unitholder in an MLP can check the value of his units in a newspaper or with a Quotron just as if it was any other publicly traded security.

Irrespective of this trading feature, there appear to be two distinguishing factors between the ownership of corporate stock and MLP units. First, the capital markets evaluate the two ownership interests in very different ways. Corporate stock frequently trades based upon a multiple of anticipated earnings, the price/earnings ratio. MLP units, however, are often valued as a function of anticipated cash distributions. Of course, projected earnings are not synonymous with anticipated cash distributions.

A second distinguishing feature of MLPs is the current inclusion in a partner's taxable income of the partner's distributive share of partnership income. In each MLP every partner runs the risk of reporting current partnership taxable income (of varying types and character) without sufficient current cash distributions to pay the resulting tax liability. As discussed above, the corporate shareholder incurs no tax liability until there is a distribution and then only if the distribution is out of corporate earnings and profits.

These relatively significant differences between MLP unit and stock ownership exist, regardless of how the units may be promoted by retail brokers. Indeed, any confusion on the part of a retail purchaser is quickly dissipated upon receipt of the purchaser's first Schedule K-1 from the MLP.

Income characterization: In light of the passive activity rules enacted as part of the 1986 Act, some commentators have suggested that a partner's share of MLP income is passive, rather than portfolio, in character. This commentary has focused on master limited partnerships as passive income generators. Some members of the Congress and officials of the Treasury have voiced a concern that a significant revenue loss may result if MLPs do indeed generate passive income. As reported by the press, senior personnel at both the Treasury and IRS publicly have said they believe they have sufficient authority under section 469(k)(3) to recharacterize as portfolio income any purported passive income generated by an MLP.

If the Congress is concerned about the character of taxable income (or loss) earned by an MLP, the Committee may wish to consider treating all MLP income as portfolio in nature. Alternatively, with the decreased significance of capital gain treatment, one could also argue for treating the MLP interest itself as a non-capital asset. This would have the effect of virtually eliminating any distortion from the use of averaging conventions for changes in MLP interests during a given month. While we do not at this time take a position on either of these alternatives, we do not believe that a concern over the character of MLP income warrants a fundamental change in the nature of the MLP as a pass-through entity.

SUMMARY

The AICPA believes that any proposal to change partnership classification should not depend simply upon the number of partners or the manner in which partnership interests are sold or exchanged. Rather, we believe that partnership classification may continue to be appropriate for MLPs. We believe the treatment of MLPs should not be altered without due consideration of the other issues that bear on the integration of our tax system; those issues should be considered and resolved in an orderly and comprehensive fashion. The MLP classification issue is simply one of these issues that happens to be more visible to the Committee at this point in time.

We thank the Committee for its willingness to consider our views and we would be happy to work with the Committee and staff to identify and seek elimination of unnecessary complexities of present partnership taxation law as it may impact on both large and small partnerships.

Chairman RANGEL. We thank you for the observations, Mr. Lerner.

Mr. Schapiro?

**STATEMENT OF DONALD SCHAPIRO, CHAIRMAN, TAX SECTION,
NEW YORK STATE BAR ASSOCIATION**

Mr. SCHAPIRO. Mr. Chairman, distinguished members, my name is Donald Schapiro, and I'm chairman of the tax section of the New York State Bar Association, which has over 3,000 members, most of whom are actively engaged in the practice of tax law.

Our executive committee considered the taxation of large and publicly held limited partnerships in some detail. There is virtually unanimous agreement among us, and we therefore recommend that the present tax treatment should be changed for publicly traded limited partnerships and for limited partnerships whose membership exceeds a numerical bench mark to be established by Congress. I will refer to such large, or publicly traded, limited partnerships as master limited partnerships.

Many of our members would recommend that all MLP's be taxed as associations. They are of the view that MLP's are the economic and practical equivalents of corporations. Some of our members suggest this result could be achieved by having Congress or the Treasury tighten up on the classification rules generally applicable to distinguishing partnerships from corporations. Such a change, however, could sweep many closely held, nonpublicly traded partnerships, into the association classification. The bulk of our members favoring taxation of all MLP's as corporations, would adopt rules related only to large or to publicly traded partnerships.

Now, a majority of our members did not endorse the view of imposing a corporate tax on all MLP's. There is substantial agreement among all our members, however, that if MLP's are not uniformly to be subject to corporate tax, Congress should adopt safeguard conditions which would be applicable to those MLP's retaining partnership tax status.

Some of the safeguards we considered would assist tax administration and assure collection of tax which is due. Other safeguards would be designed to raise revenue or to restrict the attractiveness of MLP's as alternatives to corporations.

I will now discuss the safeguard standards which were endorsed by a majority, or significant minority, of the members of our executive committee.

First, partnership audit and tax collection: There is strong support for the view that MLP's should be required to agree to a partnership level of audit and deficiency collection as a condition of continued partnership characterization.

Under this approach, the partnership would pay, on behalf of its partners, any deficiencies resulting from an IRS audit at a hypothetical maximum rate, and the partners could sue for refund.

Now, by a very close vote the executive committee did not approve a recommendation that partnerships be required to withhold tax on partnership distributions as a general method of collecting tax from the partners, but there was a very strong minority in our group who felt that withholding at the partnership level would be

appropriate as a way to collect tax which was due. My testimony gives the arguments by persons opposing it.

Now the majority of us agreed that limited partners of MLP's should be required to treat their distributive share of income as portfolio income under the new passive loss rules, at least to the extent that such income exceeds any prior partnership losses which were treated as passive losses.

The next recommendation was that the law be amended so that we get away from special allocations of items of income or loss, and we avoid the complexities of inside basis changes which go with MLP's.

Lastly, our group considered, and a substantial minority of our executive committee favored treating interest, rents, and royalties paid by MLP's as though such items were a distributive share of partnership income. This would mean that such items paid by the partnership would be regarded as active income, fully taxable as business income in the hands of pension trust, foreigners, and other persons who generally do not incur income tax on the receipt of interest income, rental income, or royalty income.

The intent of this proposal was to make certain that one full level of tax is paid on every dollar of MLP income as though it were directly received by a limited partner. This would be designed, obviously, to increase revenues, and possibly to discourage some business entities from utilizing the MLP form.

Now, obviously, Congress could adopt other safeguard conditions. Mr. Mentz mentioned other items that could be included as to which our executive committee did not act. For example: you could require distribution of all income; you could restrict partnership classification dependent on the activity of the business; you could require that all investments by limited partners be in cash, and thus discourage disincorporation. There are any number of things that could be done to the present law which would make limited partnerships, or master limited partnerships, less attractive and easier to deal with.

I want to express my appreciation for the opportunity of appearing before you on behalf of the New York State Bar Association. Thank you.

[The prepared statement of Mr. Schapiro follows:]

June 30, 1987

TESTIMONY OF DONALD SCHAPIRO
Chairman, Tax Section
New York State Bar Association

My name is Donald Schapiro. I am Chairman of the Tax Section of the New York State Bar Association which has over 3,000 members, most of whom are actively engaged in the practice of tax law.

The Executive Committee of our Tax Section has considered the taxation of large and publicly held limited partnerships in some detail. There is virtually unanimous agreement among us, and we therefore recommend that the present tax treatment should be changed for publicly traded limited partnerships, and for limited partnerships whose membership size exceeds a numerical benchmark to be established by Congress. I will refer to such large, or publicly traded, limited partnerships as Master Limited Partnerships or MLPs.

Many of our members would recommend that all MLPs be taxed as associations. They are of the view that MLPs are the economic and practical equivalents of corporations. These members would subject MLPs to tax at the entity level, and also impose tax on the equity holders on the after-tax profits distributed to them. Some of our members suggest that this result could be achieved by having Congress or the Treasury tighten up on the classification rules generally applicable to distinguishing partnerships from corporations. Such a change, however, could sweep many closely held, non-publicly traded, partnerships into the association classification. The bulk of our members favoring taxation of all MLPs as corporations would adopt rules related only to large, or publicly traded, partnerships.

A majority of our members did not endorse the view of imposing a corporate tax on all MLPs. There is substantial agreement among all our members, however, that, if MLPs are not uniformly to be subject to corporate tax, Congress should adopt safeguard conditions which would be applicable to those MLPs retaining partnership tax status.

The safeguard standards which were endorsed by a majority, or a significant minority, of the members of our Executive Committee are set out below:

(1) Partnership Audit and Tax Collection.

There was strong support for the view that MLPs should be required to agree to a partnership level audit and deficiency collection as a condition to continued partnership characterization. Under this

approach, the partnership would pay on behalf of its partners any deficiencies resulting from an IRS audit at a hypothetical maximum rate. Those partners who are taxed in lower brackets than the hypothetical rate imposed on the MLP could file claims for refund of excess amounts of tax paid on their behalf by the MLP.

By a close vote, the Executive Committee did not approve a recommendation that partnerships be required to withhold tax on partnership distributions as a general method of collecting tax from the partners. Persons urging rejection of this recommendation made the following points: (a) a withholding regime for partnerships could be viewed as discriminatory on the basis that dividends and interest are not subjected to similar regimes; and (b) partner identifications procedures under Section 6031(c) and streamlined assessment procedures authorized by Section 6222 would make withholding less important in the case of partnerships than in the case of corporations.

(2) Passive Income or Portfolio Income.

We recommend that limited partners of MLPs be required to treat their distributive share of income as portfolio income under the new passive loss rules, at least to the extent that such income exceeds any prior partnership losses which were treated as passive losses by the distributee limited partner.

(3) Special Allocations of Income and Basis Adjustments. We recommend that MLPs be prohibited from making any special allocations of items of income or loss. Further, we recommend that MLPs be taken out of the partnership regime of Code Section 754, which permits changes to the basis of partnership property as a result of transfers of partnership interests and distributions of partnership property. Also, we recommend that MLPs should not terminate pursuant to Section 708 notwithstanding a more than 50% change of ownership in one year. A Section 708 termination would cause adjustments in the basis of partnership assets. Thus, the so-called inside basis of partnership property would not change on dispositions of partnership interests. In the case of contributions of property to an MLP, we recommend adopting a so-called "deferred sale" approach similar to that used by affiliated corporations filing consolidated tax returns. In this fashion there would be no tax avoidance potential attributable to transfer of unrealized gain or loss among partners, and a uniform "inside basis" of property could be maintained.

(4) Treatment of Interest, Rents and Royalties Paid by MLPs. A substantial minority of our Executive Committee favored treating interest, rents and royalties paid by MLPs as though such items were a distributive share of partnership income. This would mean that such items paid by the partnership would be regarded as "active" income, fully taxable as business income in the hands of pension trusts, foreigners and other persons who generally do not incur income tax on the receipt of interest income, rental income or royalty income. The intent of this proposal was to make certain that one full level of tax was paid on every dollar of MLP income as though directly received by a limited partner. In part, this proposal failed to gain majority acceptance by our Executive Committee on the basis that it involved concerns broader than those affecting only MLPs and should be addressed in the context of a consideration of the integration of the corporate income tax.

I want to express my appreciation for the opportunity of appearing before you on behalf of the Tax Section of the New York State Bar Association. Thank you.

Chairman RANGEL. Mr. McGrath?

Mr. McGRATH. Mr. Schapiro, have you spoken to the people down on Wall Street regarding your recommendations?

Mr. SCHAPIRO. No, but they have spoken to me indirectly.

Mr. McGRATH. Okay. I imagine they have.

Mr. SCHAPIRO. Actually, let me answer the question, Mr. McGrath. Many of the people on Wall Street that have spoken to me, or from whom I have heard, believe that the recommendations we're making would be a reasonable way to deal with the problem. These recommendations would permit limited partnerships of the kind that people say are being used—that is partnerships which are being used to substitute for debt—to proceed.

I might also say that the administrative conditions which we've suggested here, I think, would be certainly not be opposed by the thoughtful and responsible element of any street—Wall Street included.

Mr. McGRATH. Mr. Lerner, off the subject slightly: regarding the inclusion in the technical corrections bill of a calendar year, fiscal year, solution—are you satisfied with the solution that the committee has offered in the technical corrections bill?

Mr. LERNER. We have not—I'm not aware that it is yet included in the technical corrections, but we have one that's—we're working on it now, and may well be added thereto, but it looks like the direction that the committee and the staff is going in is one that appears to be workable, Mr. McGrath. It's a difficult problem in a world of revenue neutrality to figure a solution to the fiscal year problem.

Mr. McGRATH. Somewhat complex, but it serves the purpose.

Mr. LERNER. Yes.

Mr. McGRATH. Thank you.

Chairman RANGEL. Mr. Andrews?

Mr. ANDREWS. I assume all three of you gentlemen have studied the majority of those companies that have exercised the use of MLP's.

Mr. LERNER. Well, I think as one spokesperson for an organized group: I am not an expert in MLP's. I speak for an organization. I have some clear knowledge of many of the operating similarities of some MLP groups, but I have not made a detailed study of each of the MLP's, if that's what you're asking.

Mr. ANDREWS. Have any of you?

Mr. JONES. I have not.

Mr. SCHAPIRO. No. I have not.

Mr. ANDREWS. Just let me ask you to conjecture: should the committee abrogate the opportunity for companies to elect to use MLP's, what do you think the effect will be on energy-related companies, real estate companies?

Mr. LERNER. I think there will be a very significant attempt to take advantage of the single level of tax through some other vehicle, whether that other vehicle is increased use of multiple-interest S corporations, increased use of REIT's stretching the limits of level of permissible activity of REIT's, any host of areas that might be considered viable to avail investors of one level of taxation.

Mr. JONES. I think I agree with that, that the MLP's are not the problem, they're just a symptom of a bigger problem, and that's

why we have asked that the consideration be given more broadly to the category of which organizations pay one tax, and which ones pay two.

Mr. SCHAPIRO. Mr. Andrews, it seems to me that we have on the books now a set rules imposing only one level of tax which I think, as Mr. Mentz noted, essentially involves things that are not supposed to be very active in business. I think that if the rules were changed so as to make MLP's less desirable or not available for economic activities, that those economic activities which didn't have a lot of business activity—real estate as it's now conducted, certainly stocks and bonds—would continue within the congressionally sanctioned one tax entity.

It seems to me we're addressing here a case of opening up a one-tax regime to a far broader group of economic activities than the Congress has yet consciously opened it up to, and I think that's the issue, particularly with *General Utilities* and the difference in tax rates, which we talked about.

I certainly agree with Mr. Mentz that any startup business, any economic activity which is beginning today, has got to be considered a candidate for a MLP, or a single tax entity; and the disadvantages that attend on that have to be weighed against the gigantic present value economic advantages of a single tax. To predict the result Mr. Mentz is talking about is certainly a guess. Nevertheless if one assumes that what should happen will happen in our very effective free market system, there will be immense pressure to move new activities into a simple tax system because of the huge present value differences.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Brown?

Mr. BROWN. Thank you, Mr. Chairman. Addressing my question to Mr. Schapiro. It strikes me that what your group has suggested provides a limited amount of symmetry in an area where there isn't an awful lot, and reverses the revenue approach that we take. Is that part of what the tax section was trying to get at, an evenhanded way of treatment?

Mr. SCHAPIRO. The tax section was trying to get at something like an evenhanded way, if you will. I can't speak for all of our members. Any group reaches conclusions which differ from the conclusions of any individual member. But I think the sense was to say that given everything that's gone on, the group favored establishing a new regime, call it a new REMIC, or a new REIT—call it something new—that would be restricted, would be controlled, would have its own built-in restrictive, and would operate to deal in a practical and reasonable way with the economics and the history of MLP's and the administration of the tax law.

I think you could probably get the most hard-line person in our group who thinks that MLP's should be taxed as associations, to agree that it would probably be all right to have a system imposing a series of safeguards on MLP's which would be so significant, and so absent of revenue loss, that they'd probably go along with it. That's what our group was trying to do—to work towards something that would allow, if you will, cases that would be treated as good cases to get a one tax regime, where it seemed that prior economics and tax law justified it. The proposed rule would knock out

cases where, to the sense of the group, a single tax was not justified.

We were not able, and of course it's not our function, to draw these fine lines. But we thought it was our function to bring to the attention of Congress the possibility of constructing a system which would do that.

Mr. BROWN. Well, I guess my question is: I see the symmetry in going to all partnerships, not just ones that are publicly traded—apparently that was one of the suggestions your folks have.

Mr. SCHAPIRO. Yes, but I think it was rejected, because they felt that you could, and probably should, distinguish between—let me call them small or partnerships below a certain size and partnerships above a certain size by number, and I would include in the partnerships above a certain size those that are publicly traded. I think our group recognized that different rules would be appropriate for those two different kinds of partnerships, and they would establish them.

Mr. BROWN. So your folks did the dividing line not on the basis of whether it was publicly traded or not, but on the number of people—

Mr. SCHAPIRO. Either. Either publicly traded or number. When we went through the debate in our group that you recreated here—what is publicly traded and what is not publicly traded—we were unable, essentially, to come to any conclusion that satisfied the group, as a whole. So we said, "Look, let's put a number on it and that will take care of most of the cases, and then if it's above that number we don't care whether it's publicly traded or not. We'll put it under the new rules." But remember, our new rules are not uniform taxation as a corporation. Our new rules are rules designed to make sure that the partnership tax is collected, and that the activities or method by which it's run does not result in—as we saw it—in a major change in the economics.

Mr. BROWN. I guess what I was trying to get at is: does your group think this symmetry ought to apply to the other areas, like subchapter S, and REIT's, and REMIC's—I'm trying to figure out—

Mr. SCHAPIRO. Mr. Brown, I think our group recognizes the life of the law is not logic. We know that there are differences. Subchapter S corporations are restricted to 35 people, and the other pass-through entities have no active business. We couldn't really see, as a group, any method of reaching within any foreseeable future, the kind of uniformity that would enable everyone to say this is a perfectly sensible, symmetrical tax world. We couldn't do it, and we said, "Let's recognize that. Let's take MLP's. Let's sterilize, in many ways, their perceived bad features and let them go on."

Mr. BROWN. But you see the problem we have. I mean, if I can frame it—maybe you'd disagree—but I think part of the problem we've got is that you have a rate structure that influences people to take an option where they can avoid the double tax, or take the lower initial tax, and what we're doing is putting our fingers in holes in the dike without dealing with the problem. It seems to me if you put a finger in this hole, what you do is encourage people to use subchapter S more, or use REIT's more—I'm not sure we've dealt with the fundamentals by this approach, have we?

Mr. SCHAPIRO. The answer, Mr. Brown, is: of course you're right, that with the difference in tax there will be that impetus. But access to subchapter S is restricted to 35 people. That's not a major publicly traded operation. And access to the REIT's, the REMIC's, and the RIC's, is access only for activities that don't involve active business. So, in reality, the law, as it now exists, while it's not uniform totally, does operate to provide bulwarks for a double tax.

I fully agree with you that as long as there is a higher corporate tax than individual tax there will be huge efforts put in to do away with the corporate tax. But present law doesn't really allow it in too many cases other than, if I may say so, the MLP's. And that, I think, is what Mr. Mentz has been talking about. MLPs are an undefined, uncharted, unregulated method of avoiding the corporate tax.

Mr. BROWN. I wonder if I can ask the panel— maybe you, Mr. Jones, or others that might join in—to walk us through what the mechanics are of an MLP. You mentioned, I think, Mr. Jones, in your discussion, the problem of producing the paperwork—or at least referred to it—of operating; that it was some sort of barrier for everyone to move to an MLP. Could you just give us a quick run-through of what that is, what it amounts to?

Mr. JONES. Well, perhaps I could just mention a couple of problems which occurred to us—and there are others.

When we talk about master limited partnerships trading, we mean that they trade in the brokerage houses, people buy things for people's account—the pattern in brokerage houses, very much, the whole thing's in street name. Street name runs directly contrary to the basic spirit of partnership that you know who the partners are and that you can trace them through. It introduces a whole level of complexity, and there are various methods whereby people are dealing master limited partnerships trying to preserve their street names while satisfying the revenue requirements. That's one type of thing.

Another area is that partnership taxation has grown up over many years—it's a very sophisticated system—to passthrough tax to individual partners, particularly when there are trades. People get in and out of partnerships, before and after income is recognized, when special events occur.

The basic method of regulation of partnership taxation is to make rather subtle and complicated adjustments to basis. Well, that's directly antithetical to the idea of publicly traded where all the units must be fungible, and people buy something that's just like everything else. If they have to inquire what the basis is of this particular unit, it will be more or less valuable than something else, and then you don't have a market any more. Those would be—

Mr. BROWN. How do you do the accounting on those basis adjustments? I mean, do you maintain a whole separate record for every partner?

Mr. JONES. In the typical partnership that's what you do. There have been shortcuts—and perhaps some of my colleagues can say what the MLP community has tried to come up with as a substitute for that kind of accounting.

Chairman RANGEL. Let me thank this panel. We had thought that we would go straight through, but those bells mean that we have votes on the floor, so we will recess for a half hour. But before we do I want to thank this panel for the objectivity and professionalism which your associations have always brought to discussion of complex tax legislation, and in the event that you see that the subcommittee or full committee is moving toward change in the rules in this area, I hope that you would be willing to go back to the drawing boards, and in some of the recommendations that you made in rather broad general terms, that you might think about making more specific recommendations as relates to safeguards or size or other questions. But, Mr. Schapiro, I'm proud of the reputation that our bar association has and the professionals you bring, and naturally the CPA's and the national.

We will recess until 12:30, and I think that by that time we would have completed our votes on the floor.

[Recess.]

Mr. ANDREWS. The subcommittee will come to order. Our next panel is composed of two witnesses: Mr. Richard G. Cohen of the firm of Winthrop, Stimson, Putnam & Roberts. He is the former chairman of the tax section of the New York State Bar Association, and former reporter for the American Law Institute, Subchapter K Project; and Mr. Hart H. Spiegel of the firm Brobeck, Phleger & Harrison, from San Francisco, Calif. He is the former Chief Counsel of the IRS.

Mr. Cohen.

STATEMENT OF RICHARD G. COHEN, ESQ., WINTHROP, STIMSON, PUTNAM & ROBERTS, FORMER CHAIRMAN OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION AND FORMER REPORTER FOR THE AMERICAN LAW INSTITUTE, SUBCHAPTER K PROJECT

Mr. COHEN. Thank you, Mr. Chairman. I appreciate the opportunity to speak to your committee today.

The American Law Institute recently completed an 8-year study of partnership taxation. As part of that study, the institute considered which entities should be classified for tax purposes as partnerships. Before getting into the classification issue, I might briefly mention that the study, itself, which was part of an American Law Institute project, was headed by Stanley Surrey, a former Assistant Secretary. The reporter was advised by a group of distinguished practitioners and academics who served as consultants.

Over the 8-year period a number of proposals were developed. These included restrictions on loss passthrough by partnerships, special partnership allocation rules, rules on disguised sales to partnerships, and the entity audit of partnerships. Many of our suggestions, including all of the foregoing, were adopted—either legislatively or administratively. Many others have been endorsed by other professional groups such as the tax section of the American Bar Association and the New York State Bar Association.

The ALI concluded that MLP's—we didn't use that term, then, they were just coming on-stream. We referred to them as publicly traded partnerships. We concluded that publicly traded partner-

ships had many of the characteristics of corporations, and to us it seemed appropriate to tax them like corporations.

In our recommendation we recognized that Congress had previously taken a number of corporate entities and exempted them from the corporate tax—treated them on a passthrough basis. I refer here to regulated investment companies, REIT's, such entities as oil exploration vehicles, et cetera. Such entities are appropriately exempted from corporate tax when they operate as corporations, and if they were to operate as MLP's they should also be exempt from tax. I note that Treasury supports such special treatment for oil and gas wastes limited partnerships.

The issue that faces your committee today is one of control: whether Congress is going to determine which publicly traded entities are subject to tax, or whether individual entities are going to, in effect, elect passthrough treatment.

There has been extensive discussion of integration throughout the 1970's in particular. Despite support from a broad sector of the tax community and the investment community, integration didn't become law.

In the American Law Institute view, and in my view, integration is something that should be considered directly by Congress. The decisionmaking power on this issue should be in congressional hands and not in the hands of the taxpayer.

If entities can form as MLP's and avoid corporate tax in that way, you're giving up a lot of that choice. If Chrysler, for example, starts operating as an MLP, or if a major part of its profits are funneled through an MLP, which is taxed as a partnership what is Congress going to do when General Motors and Ford come along and say they deserve similar treatment? The ball may be out of congressional hands at that point. So I think prompt action on this issue is appropriate.

Should Congress wait to act on MLP's before the Treasury study on subchapter C is complete? The results of that study are unlikely to help on the MLP issue. I'm not aware that Treasury is making a major study of integration. The revenue issues that Secretary Mentz referred to, almost in passing, are so substantial that integration is not really a possibility this time around. And if Congress is not going to adopt integration, then it's a mistake to allow MLP's to proliferate. You're going to have self-help integration that Congress does not control.

A good deal has been said about the difficulties of applying the partnership rules to MLP's. I think that many of the speakers today will discuss that. I share the views of Don Schapiro, who spoke for the New York State Bar's tax section—and John Jones, who spoke for the American Bar Association, that substantial changes are needed to subject them to the regular partnership tax regime.

Thank you for giving me the opportunity to address this committee, Mr. Chairman.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF RICHARD G. COHEN, ESQ., WINTHROP, STIMSON, PUTNAM & ROBERTS,
NEW YORK, NY

My name is Richard Cohen. Thank you for asking me to speak today.

I am an attorney specializing in federal income tax matters, and practicing law in New York City. From 1976 to 1984 I was the Reporter for the American Law Institute's study of the partnership tax provisions and was recently chairman of the Tax Section of the New York State Bar Association. My comments today, however, are in a personal capacity and should not be taken as representing the views of either the American Law Institute or the New York State Bar Association.

The American Law Institute recently completed an eight-year study of partnership taxation. As part of that study, the Institute considered which entities should be classified for tax purposes as partnerships. The ALI concluded that entities formed under a version of the Uniform Partnership Acts should be taxed as partnerships but the proposal specifically excepted partnerships with publicly-traded interests. We were concerned that in such partnerships the interests were much more like stock than like traditional partnership interests, particularly in being highly liquid and fungible.

When the ALI considered the issue, there was only one partnership listed on a major stock exchange. Now, of course, additional master limited partnerships ("MLPs") are added to stock exchange listings almost on a weekly basis.

Tax MLPs as Corporations

Manufacturing and other MLPs which are publicly traded and not engaged in traditional partnership activities should be taxed as associations.

MLPs erode the corporate tax base. We have now seen that MLPs can be used to conduct almost any business. Moreover, there is no longer a trade-off between a lower current tax at the entity level and the cost of distributing funds to pay the taxes of the owners. Because tax rates for corporations are generally higher than those for individuals, it is now cheaper for a business to make a distribution to its owners to pay their taxes on its income than for the business to pay the corporate tax.

The inroads of MLPs into businesses traditionally conducted by tax-paying corporations have been modest so far. However, we are witnessing an acceleration of a trend of forming new businesses as partnerships and later bringing them to the capital markets in partnership form. In contrast, existing corporations face an extremely heavy cost in converting to partnership form, particularly in light of General Utilities repeal. It makes no sense for the tax system to favor new entrants to the capital markets over older enterprises in this way.

Other Methods of Circumventing Corporate Tax

Operating as an MLP is, of course, only one way of bypassing the corporate income tax. The corporate tax is also being bypassed by so-called "junk bonds" -- bonds issued with returns that are similar to some extent to

equity returns but on which payments by the issuer are deductible. "Market rate" preferred stock -- stock issued with returns that are far less than market interest rates but which are designed to be equivalent on an after tax basis to corporate bonds -- also erodes the corporate tax base. Such preferred stock is designed to be sold to corporations that can take advantage of the dividend received deduction. The "dividend" on this preferred stock is usually reset at regular intervals to take account of changes in market interest rates.

Other Considerations

There are other tax problems inherent in classifying MLPs as partnerships, although they may not in themselves warrant taxing MLPs as corporations. The major classes of technical problems raised by MLPs other than erosion of the corporate tax base are:

1. Uniform income and loss to all holders of the partner interests in a given class

Section 704(c) requires differentiation between partnership interests that were originally obtained by contribution of appreciated or depreciated property and those obtained in return for a cash contribution to the partnerships. Even with a §754 election in effect, this difference often carries over to purchasers of partnership interests. Indeed, the §754 adjustment itself can produce differences in treatment, such as the fact that depreciation on the §754 adjustment is often subject to different rules than depreciation on the underlying property.

MLPs typically try to make offsetting allocations to give each holder the same share of income and loss despite §§704 and 754. These allocations are, at a minimum, highly questionable. The pressure for such allocations is largely limited to publicly traded partnerships, however.

2. Audit and collection of taxes

An MLP is subject to audit as a single entity, like most other partnerships. However, taxes due as a result of any audit adjustment have to be collected from the partners. When interests in an MLP are publicly traded on a stock exchange, the number of persons who held interests during a part of the year in question may be huge and many of them may owe only a tiny amount. Collection may not, therefore, be practical.

Large partnerships could be required to pay a "withholding" tax (at the maximum individual tax rate) on their income and allocate the payment as a creditable tax payment to their partners. If the income of the partnership is adjusted for a year, the partnership would have to pay any additional "withholding" tax corresponding to the adjustment. A similar technique is already in place for payment of the windfall profits tax.

3. Difficulty of Classification Under Present Regulations

A third technical problem raised by almost all MLPs is that under the Section 7701 classification regulations, they are usually close to the borderline between corporations and partnerships. The regulations classify an entity as a partnership if it lacks two or

more of four specified "corporate characteristics". Almost automatically, most MLPs have two of the corporate characteristics (free transferability of interests and centralized management). Hence any MLP generally makes only the minimum possible showing to fit within the regulations.

However, the MLP problem should not be addressed at this level. The present regulations (which were drafted to prevent professional associations from being classified as corporations) do not provide a sensible dividing line. They are not directed at economic reality but at technical details. This is one of the reasons that the ALI proposed that UPA and ULPA partnerships not publicly traded should invariably qualify for taxation as partnerships.

Which partnerships should be taxed as associations

The main reason for taxing some partnerships as corporations is to prevent erosion of the corporate tax base. That is why MLPs, which are basically economic substitutes for corporations, should be taxed as such.

However, the characterization should not be based solely on size. For example, many professional partnerships have more than 35 partners but are appropriately taxed as partnerships.

Partnerships in which interests are publicly-traded on a securities exchange should generally be taxed as corporations. If partnership interests are initially sold on the understanding that someone (such as a brokerage house) will make a market in the interests, the partnership should probably be taxed as a corporation. It does not, however, seem appropriate to tax as a corporation any entity that would otherwise be properly taxed as a partnership if the beneficial ownership is not traded on some more-or-less formal market.

Moreover, there are many partnerships with publicly-traded interests that are not appropriate candidates for the corporate tax. Some activities have long been carried on in significant part by pass-through entities and therefore, when carried on by a publicly-traded partnership, do not present a threat to the corporate tax base. Among these are real estate holding companies and other entities which own interests in (but don't actually carry on the extraction of) natural resources. Similarly, investment companies that hold passive interests in other enterprises have been taxed as pass-through entities, similar to partnerships, and do not represent a threat to the corporate tax base. The principal examples are investment funds and issuers of collateralized mortgage obligations.

This list is not meant to be exhaustive and I'm sure there are other activities which should be added. However, as a general rule, any publicly traded entity which itself conducts significant active industrial, extraction, manufacturing or selling activities should not qualify for exemption and should be subject to the corporate tax.

Mr. ANDREWS. Thank you, Mr. Cohen.
Mr. Spiegel?

**STATEMENT OF HART H. SPIEGEL, ESQ., BROBECK, PHLEGER &
HARRISON, FORMER CHIEF COUNSEL OF IRS**

Mr. SPIEGEL. Thank you, gentlemen.

By reason of my association with the Treasury some years ago I have a very high regard for these gentlemen, but I think they are misguided, and I'd like to explain why by a couple of examples which are familiar to me.

I'm counsel for a corporation in the entertainment business. It desires to expand, but already has \$50 million of junk bonds outstanding—or "high yield bonds" is a more elegant way of stating it—and their friendly bankers tell us we can't borrow any more money. Conceivably we could issue more common stock, but that would deprive the owners of control of the business.

Right now, under present law, we can transfer some of the assets to a limited partnership, take back the general partnership interest, and sell off the limited partnership interests and raise \$60 or \$70 million. We'll pay off the \$50 million of junk bonds, and we'll have \$20 million left over for the expansion we desire. I ask you: what conceivable purpose could Congress have in forbidding that transaction?

Right now, on the \$50 million of junk bonds we have outstanding, we're deducting the interest, and we're not paying any tax, and the bondholders—pension plans, universities, foundations, and exempt entities—they're not paying tax either. So on that \$50 million of capital, the Government gets no money at all, no revenue at all. If we're allowed to have this partnership, we'll have \$70 million of partnership units outstanding in the hands of individual investors paying tax, at least at the individual income tax rate. I say to you: what purpose is served by snuffing out that transaction.

Let me give you case two. We represent a construction company which also has large timber reserves. It needs to expand and needs money. Now, we can issue junk bonds for corporate debt and go through the same minuet I've just described. We'll deduct the interest, the institutional investors will not pay tax on it, and the Government will get no revenue whatsoever. On the other hand, we can roll out the timber to a limited partnership, retain the general partnership interest, sell off the limited partnership interests, and finance our expansion that way, and the Government gets one tax for sure from the individual investors. What earthly purpose is served by forbidding that kind of financing?

I was interested in these schedules that Roger Mentz presented. Table III, showing this growing cancer that is going to develop if we allow partnership interest to proliferate. I think we ought to add another schedule to that table III. We ought to have a table showing the amount of partnership interests that have been issued in the last five years, because that's when this started. It's a little over \$6 billion of publicly offered limited partnership interests. There ought to be a table showing how much revenue the Government has got from that \$6 billion of partnership units. It's a fair piece of change, because it's all taxed at individual rates; and

there's a tremendous startup tax cost for most of those limited partnerships.

Then, below that, let's have a schedule showing the amount of junk bonds that have been issued—or high-yield bonds—in the last 5 years: \$660 billion. And let's have a schedule showing how much revenue the Government has collected on that \$660 billion. To the extent it's owned by pension plans, by life insurance companies, by universities, and by foundations, the government hasn't collected two tamale wrappers. It's all been exempt from tax.

I say to you I'd like to see a schedule where the Treasury would say that that's good economics to issue junk bonds on which the Government gets no tax, as opposed to limited partnership interests on which it's assured of one tax.

Most of these schedules are—it seems to me they overlook the fact that much of the capital in this country is raised by one of three ways: either by issuing common stock; by issuing bonds and debt; or by, hopefully, limited partnership interests. And for the life of me I can't understand why a debt—which is the real alternative—seems to be preferred, when the government gets so little revenue from it. Your colleague, Pete Stark, would say that even when the junk bonds are owned by life insurance companies you don't get much tax.

Now, I've got nothing against Drexel Burnham—in fact, they've helped us many times, and they're square shooters and very decent people—but they issue junk bonds, and I think that junk bonds are a bigger problem in this country than limited partnership interests.

Let me give you one final example. In the oil and gas industry, which has been a rather tax-favored industry for years, and probably will continue to be, there are three ways you can go about raising money if you want to go into a drilling program. You can get together a group of millionaires, form a nice, small, limited partnership, and you're in business. Or you can get a larger group of well-to-do investors who can satisfy the laws in the corporation commissioner's State offices regarding their net worth, and issue units in a publicly offered partnership, as it has been denominated today. Or, third you could have a publicly traded limited partnership where the general public can participate.

Now I ask you: what purpose does Congress serve by saying that in this industry we're going to allow the millionaires to participate, we're going to allow the well-to-do to participate, but we're not going to allow the general public to participate? And that's the net effect of this proposal that the Treasury's offering.

I say to you: this is not a clear, cool pond the Treasury asks you to jump in to. It's a pond that's full of alligators, and I think that if the committee does not look long and hard it's going to find out there are a lot of problems that it didn't anticipate. My only thought is: I think it's fine to study it. I think it should be studied. I know there are problems, but I think that it ought to be studied and not acted precipitously in the fashion that has been suggested today.

[The prepared statement of Mr. Spiegel follows:]

Statement of Hart H. Spiegel
Before Select Revenue Measures Subcommittee
of the Ways and Means Committee
of the United States House of Representatives

June 30, 1987

My name is Hart H. Spiegel. I am an attorney, a partner in the firm of Brobeck, Phleger & Harrison in San Francisco. I have practiced tax law for 40 years; and I served as Chief Counsel for the Internal Revenue Service during the period 1959-1961. While memories of my government service have dimmed a bit, I still look back on those days as the most interesting, enjoyable and rewarding professional experience I ever had.

I come before you today because I believe the Treasury is urging a change in the law which will not prove to be in the best interest of either the Treasury or our country. I refer to the proposal to tax publicly traded limited partnerships as corporations. I suggest this proposal is ill advised for four reasons:

First: While the surface issue is whether publicly traded limited partnerships should be taxed as corporations, the critical underlying issue is whether capital formation and new financing should all be accomplished by sale of "junk bonds" and other debt instruments, or whether there is not a niche for capital formation by sale of limited partnership interests. I believe it is a demonstrable fact that the majority of publicly traded partnership units have been issued as a substitute for corporate debt, or "junk bonds". If publicly traded limited partnerships are taxed as corporations, then you may be assured that "junk bond" debt financing will continue to be the primary source of new capital. On the other hand, if publicly traded limited partnerships are allowed to function as they now do, then at least for some industries and in some circumstances there will be an alternative means of capital formation. And I say to you that any investment vehicle which will enable those in need of capital to raise it by legitimate equity financing rather than debt financing should not lightly be legislated out of existence.

Second: I seriously question whether the alleged revenue losses which are viewed with alarm by some commentators, if publicly traded limited partnerships are allowed to continue, will in fact occur. In simple terms, with partnership financing, one tax at the partner level is paid by all partners, be they taxable or exempt entities. With "junk bond" financing by corporations, substantially no tax is paid on the capital thus raised -- the corporation deducts the interest on the bonds while the institutional buyers of the debt instruments e.g. pension funds, insurance companies, universities, charitable foundations, and the like, pay no tax on the interest because they are tax exempt or nearly so.

Third: There are valid business and legal reasons why publicly traded limited partnerships should be taxed as partnerships and not as corporations. The skies are not going to fall if the Committee takes the time carefully to

consider these complex issues. Only now are we really beginning to get hard factual data about the actual functioning of publicly traded limited partnerships; and this data should be studied as well as the theoretical position papers on the subject.

Fourth: If publicly traded limited partnerships are taxed as corporations but all other partnerships continue to be taxed as partnerships the result will be to deny to the small investor and the public the investment opportunities reserved for the rich and well-to-do.

Let me speak briefly to each of these points.

First: It is a gross over simplification of the problem to suggest that the only result of publicly traded limited partnerships is to foster do-it-yourself integration by which only one tax is collected on business income; whereas if a business is conducted in corporate form two taxes are collected on the income. This reasoning leads inevitably to the conclusion that publicly traded limited partnerships will drive corporations out of the tax world and America will disincorporate.

Four years ago this scenario was predicted in an article in Forbes magazine; and the doomsday prophecy was repeated in June and October of 1986. In fact, no such mass exodus to publicly traded limited partnerships has occurred. On the contrary, it has become increasingly apparent that publicly traded limited partnerships are not a substitute for corporate operation of a business; but rather a specialized and limited means of raising capital (other than by debt financing), which is best suited to certain industries, particularly the oil and gas and real estate and timber industries. It has also become increasingly clear (a) that tax exempt institutional investors (pension plans, foundations etc.) will not invest in publicly traded limited partnerships because of concern that distributions will be taxed as unrelated business income; and (b) that capital raised by issuance of publicly traded partnership units is most often used as a substitute for debt.

The critical question is whether Congress is concerned with the massive increase in corporate debt. I believe it is. The next question is, if it has such concern does it have any feasible program for reducing corporate debt or making it less attractive. I believe it does not. I think it is fair to say that Congress will have a very difficult time reducing or limiting the use of corporate debt by legislation. The time honored interest deduction for business debt is too deeply engrained in our tax law to be removed. This being the case, the best solution is to provide taxpayers with an alternative to debt financing. In a nut shell, that is what publicly traded limited partnerships have turned out to be. In certain industries under certain circumstances it has been found feasible to acquire new capital through the sale of limited partnership interests rather than through the issuance of junk bonds or other corporate debt instruments.

In short, the real issue is whether publicly traded limited partnerships should be allowed to continue as an alternative means of raising capital. Since 1982 when the

first such partnership was organized, approximately \$4.4 billion of partnership units have been sold to the public as of January 1987. During the same period, approximately \$534 billion of corporate debt was sold. I suggest to you that the country would be a lot better off if the figures had been reversed -- if \$4.4 billion of corporate debt had been issued and \$534 billion of partnership units were outstanding. It seems quite clear that institutional investors are disinclined to invest in partnerships and corporations have nearly the same aversion, the financing will have to come from individual investors, and has in fact come from small individual investors. This is not only good economics but almost guarantees that publicly traded limited partnerships will not become a major factor in the capital markets.

Second: This brings us to the second issue -- assuming the country would be in better shape economically if publicly traded limited partnership units were more numerous and corporate debt were far less, how would the Treasury fare. I respectfully submit that the Treasury would do very well. In respect of the capital represented by this \$534 billion of corporate debt, the Treasury is not collecting two taxes. It is not collecting one tax. It is most probably collecting no tax. The corporation which issues the debt deducts the interest; and the lenders who purchase the "junk bonds" or other debt instruments are, by and large, institutional investors who are tax exempt or pay little if any tax. Accordingly, in respect of this corporate debt, the Treasury, far from collecting two taxes, is well on the way to collecting no tax.

On the other hand, most publicly traded limited partnership units are owned by individual investors and of equal importance, by small individual investors. In a survey made by Dean Witter & Co., probably the leading underwriter of publicly traded limited partnership offerings, it was determined that as of January 1987 the median investment was about \$5,000. And these small individual investors are not tax exempt entities.

It may be suggested that corporations which are capitalized with debt and deduct the interest payments thereon, nevertheless generate excess income which remains subject to tax, first at the corporate level and second at the shareholder level when the income is declared out in dividends. But much of this income is retained by the corporation so that no double tax is incurred; and while a tax may be incurred at the shareholder level some time in the future it may be a very, very long time in the future.

Moreover, even in respect of the corporate income generated by debt financing, which is distributed to shareholders as dividends, much of it is not taxed either because the shareholder is a tax exempt institutional investor (e.g., pension funds) or is a corporate shareholder entitled to the dividends received deduction. On the other hand, partnership units are anathema to institutional investors because of their concern that distributions will be considered unrelated business taxable income and subject to tax in spite of the tax exempt character of the institutional investor. Accordingly, there is little chance that any publicly traded limited partnership income will not be taxed at the unit holder level.

Finally, the Treasury receives an "up front" tax payment on the formation of a publicly traded limited partnership "roll out" from an existing corporation -- generally undertaken to raise capital. Unlike offerings of corporate stock, these transactions are for the most part treated as sales of assets and the sponsor corporation is taxed on the difference between the proceeds received for the partnership units and the corporation's tax basis in assets "rolled out". The resulting initial tax payment can be of considerable magnitude, particularly if there is substantial investment credit and depreciation recapture associated with the rolled out assets.

Third: There are valid business and legal distinctions between publicly traded limited partnerships and corporations. These distinctions suggest that different tax treatment is appropriate and that non-tax considerations will often dictate that the corporate form be used. The significant distinctions include -

(a) If the business is conducted in corporate form, no personal liability attaches to the shareholders. In a partnership, the general partner is fully liable for partnership liabilities, and even the limited partners have some exposure. For example, creditors generally have the right to seek return of capital distributed to a limited partner if the liability for which payment is sought arose before such distribution. This right survives a partner's termination of his interest. I can say from personal experience that finding an individual of means to serve as a general partner in a publicly traded limited partnership is no easy task.

(b) A limited partner may incur tax liability without having cash to pay the tax. A limited partner is taxed on his share of partnership income even if such income is used to amortize debt or acquire assets, and no cash is distributed to him. The result of this circumstance is that limited partnerships cannot and do not use debt financing in the same fashion as corporations. A further result is that limited partnerships tend to become self-liquidating - as assets are sold, the proceeds of sale are distributed and not reinvested.

(c) The accounting costs and complexity of operating a partnership are a deterrent to all but the larger partnership entities. Even though the accounting fraternity has about mastered the techniques for keeping track of and correctly reporting to the partners their distributive shares of partnership income, the costs and required expertise are a deterrent to use of the partnership form.

(d) Publicly traded limited partnerships are generally restricted in their business purpose to a well defined activity and management flexibility is limited.

(e) Partnership units are anathema to institutional investors because of their concern that the units will generate unrelated business taxable income. Accordingly, a limited partnership's access to the capital markets is drastically reduced. Investment bankers are not eager to underwrite a public offering in which the only market is

individual investors -- and small ones at that. I know personally of several partnership offerings which have been scrapped because of this limited marketability.

In short, publicly traded limited partnerships are sufficiently different from corporations, both legally and functionally, to justify a different method of taxation. I would add that there is little logical justification to classify business entities on the basis of the liquidity of their equity interests. Most corporations are not publicly traded, yet they are subject to a double-tax because they have adopted the corporate form. To be consistent and neutral, business entities that operate as partnerships should be taxed as such, even if their interests are liquid.

Fourth: To legislate against publicly traded limited partnerships is to say that whatever business and tax advantages are available from the partnership form shall only be available to the wealthy and relatively wealthy. The partnership tax provisions have been a part of the federal tax system since its early days. Recent proposals have not attacked partnerships per se, but only partnerships which have more than a certain number of partners, or, as now under consideration, which are publicly traded. To my knowledge, no one has suggested that the partnership form not continue to be available as an alternative business structure vehicle.

Partnership offerings can be divided into three general categories:

1. Private Placements: Partnership interests offered to a small number of investors, requiring an investment of \$50,000 - \$100,000 and an investor net worth of \$1 million. These partnership interests are not publicly traded.

2. SEC Registered Offerings: Partnership interests offered to substantial numbers of potential investors, generally anticipating an investment of \$1,000 - \$5,000 and a net worth of at least \$30,000. These partnerships may have hundreds or even thousands of limited partners, but the partnership interests are not publicly traded.

3. Publicly Traded Limited Partnerships: Partnership interests which are available for purchase by anyone without any net worth or other regulatory requirements and are listed on, generally, the New York Stock Exchange. These partnership interests are publicly traded and can be sold by the owner at any time.

Because of the above-described qualification requirements imposed by Federal and state securities laws, private placements are only available to the very wealthy, and SEC registered offerings are only available to the relatively wealthy. Only publicly traded limited partnerships are available to the general public. If publicly traded limited partnerships are now to be treated as corporations, what is the result? The result is that the wealthy and the relatively wealthy will continue to enjoy the business and tax advantages of the partnership form, but the general public will not be so entitled. The Congress has

spent much of its time over the last seven years in its attempts to ensure that the wealthy of this country pay their fair share of taxes. Ironically, characterization of publicly traded limited partnerships as corporations would have the opposite and, I believe, clearly deleterious effect.

One might respond then, of course, that the proposition should be to treat all partnerships as corporations so that no one has the possibility of utilizing the partnership form. However, to legislate all partnerships out of existence would be a momentous decision which would have far reaching ramifications outside of the tax area. Utilization of the partnership form in business operations, particularly small businesses, vastly exceeds the use of corporations. The reason for this is that the partnership form permits investors and entrepreneurs to have a flexibility in structuring their business relationships which is impossible or very difficult to achieve under the statutory rules applicable to corporations. The absence of any proposal to tax all partnerships is an indication that everyone who has considered the issue has concluded that the partnership form is a desirable business form. To conclude, nevertheless, that partnerships which are publicly traded should be treated differently is merely to conclude that an investment opportunity which is available to the wealthy and relatively wealthy should not be available to the general public. Thus, a vote to treat publicly traded limited partnerships as corporations is not only a vote to terminate a very desirable equity raising vehicle, but also is a vote to cause the tax laws to offer the rich greater flexibility and investment opportunities than is offered the general public.

Conclusion

One of the most serious problems this nation faces is the proliferation of "junk bonds" and the burgeoning corporate debt structure. To date neither the Treasury nor Congress has been able to fashion a solution. So long as business interest is deductible, corporations will continue to use debt as a means of capital formation; tax exempt institutional investors will continue to be the principal purchasers of such debt; and the do-it-yourself integration inherent in the arrangement will continue to flourish. In fact, as noted above, with corporate debt being purchased by exempt entities, the integration is so complete it wipes out substantially all tax on such capital.

Publicly traded limited partnerships are an alternative means by which corporations or other business entities can raise capital without parting with control. The partnership units are generally owned by small, individual investors who are not tax exempt. And the federal fisc is assured of one tax on the partnership capital -- not promised two taxes while frequently collecting none.

The dire predictions for the past four years that America would disincorporate have not come to pass. What has actually been demonstrated is that for certain industries and for limited purposes, publicly traded limited partnerships provide an effective alternative for capital formation. However, publicly traded limited partnerships

are never going to become a major factor in the capital formation market because their appeal is to small individual investors who play a relatively minor role in capital formation (as contrasted with institutional investors, corporations etc.). But why should these individuals be excluded from participation; and, if the individual investor obtains any tax advantage from investing in a limited partnership, why should only the wealthy or the well-to-do be allowed this advantage.

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Mr. ANDREWS. Thank you, Mr. Spiegel.

Mr. COHEN, would you care to comment on that? [Laughter.]

Mr. COHEN. First, Mr. Chairman, let me say that the early part of my professional career was spent under Mr. Spiegel's aegis at the Internal Revenue Service, and it was a great pleasure then. [Laughter.]

I think that we form a perfect panel, I suppose, in that—well, let me say: one aspect of Mr. Spiegel's views that I would be willing to associate with is that there is an enormous revenue loss through debt, and particularly through equity-type of debt instruments such as junk bonds. I think that your committee, and your Congress, is going to have to address that within the next several years.

Mr. ANDREWS. But wasn't Mr. Spiegel really saying, "If we're going to look at MLP's, we need to put them in the total context of these other debt vehicles, like junk bonds, and are we being premature if we take a run at MLP's this month and wait to some future time to look at junk bonds"?

Mr. COHEN. Well, I certainly, Mr. Chairman, agree that that's what Mr. Spiegel was saying. Whether I agree with that would be another matter. I think that the economy—maybe this is simplistic, but the economy got along until 1980 without publicly traded limited partnerships, and they were able to raise capital, and we were able to achieve whatever industrial might we have against that background.

I think that I doubt that serious harm will be done if Congress now cuts off the formation of MLP's and says, "Wait a minute. We want to stop. We want to decide whether this is revenue that we're willing to give up." Maybe you'll decide it is. In the REIT area: you thought about it, you decided that the kind of real estate entity that uses something like a limited partnership should be allowed to operate on a passthrough basis. You said that in the mutual fund area, and the RIC area, and it makes a lot of sense to me. It makes an awful lot of sense.

I think if you get into it under the pressure that's now being put on by the number of people who want passthrough treatment, I think you will greatly expand existing passthrough treatment. We've mentioned oil and gas, they'll probably be a broader real estate exemption than is now provided by REIT's, and certainly the movie industry is another possibility. But I don't think you want to wake up tomorrow and find out that a lot of active business are using MLP's, and you've got to either take it away from them on some fair basis, or grant it to all active businesses.

Mr. ANDREWS. In the last couple of years several energy companies in the producing States have used MLP's to raise capital very quickly. Had they not had that avenue, what do you think would have happened?

Mr. COHEN. Well, they—

Mr. ANDREWS. Are you suggesting they would just have found another way to do it?

Mr. COHEN. For energy companies, Mr. Chairman—I don't know the specific example you have in mind—but in the oil and gas industry they've been able to achieve passthrough treatment for many very large investments. I think that they could continue to do that, whether MLP's are available or not. It's not the exclusive

passthrough entity in the oil and gas industry. Take a more active business—say a steel company—to my knowledge they haven't yet begun operating as MLP's. You have to ask yourself if you're expecting a corporate tax from them. You're expecting so much corporate tax each year; what will you do when entities that are supposed to produce that tax elect MLP status?

Mr. ANDREWS. Mr. Spiegel, would there have been negative consequences, in your view, without MLP's as a vehicle to raise capital?

Mr. SPIEGEL. Well, I think what would have happened is just what I have said: the oil industry would go to these syndicated partnerships and they would sell it to people that have a net worth of \$100,000, and an income of \$80,000 a year, and the Securities Commissioner says, "Yeah, you can sell them this kind of a partnership unit." But they wouldn't be able to sell them to the average investor.

Or they would go, if you eliminate that and say they were not even going to have syndicated partnerships, then they'll go to the millionaires club, and they'll get the money that way.

My problem with this whole analysis is—and I think you put your finger on it—I haven't heard of any Congressman, any economist, or anybody in the administration, say we ought to have more debt, more corporate debt. Not one. And here we have a program which has some possibility of carving out at least a niche where we don't have to add to our corporate debt, and everybody's all over us. And furthermore it's costing us revenue. This corporate debt, believe me, is no monkey business. When you've got \$600 billion of debt out there, and most of it in the hands of pension plans, life insurance companies, foundations, charities, and universities, paying no tax at all, what are we doing talking about, "Let's have some more debt out there"?

Mr. ANDREWS. Mr. Cohen, you said in your testimony that you felt like you knew what the study was going to show?

Mr. COHEN. The Treasury study, sir.

Mr. ANDREWS. The Treasury study that's ongoing. What's the urgency? Why don't we wait? How are you so sure that you know what the conclusions are going to be from that study? Why should this panel move so expeditiously on this single issue of MLP's until we have that study? Why? Is it not useful at all?

Mr. COHEN. Mr. Chairman, it would be unfortunate if Congress rejected integration, but found that there was de facto integration because MLP's had proliferated. Are you going to be able to maintain that three companies in the computer industry, for example, can pay tax, and two don't have to pay tax, can operate on a pass-through basis? If Congress doesn't act promptly on this issue, it will find that the decision's been made for them, that integration has become the law.

I have not heard that integration is being seriously considered at this time. When the tax section of the New York State Bar and the American Bar Association met at their subchapter C conference in Reston, Va., there was very little talk about integration. There was talk instead about preserving what's left of the corporate tax. Mr. Spiegel has addressed himself very eloquently on the subject of preserving what's left of the corporate tax by limiting the use of debt.

I think that the MLP's, if a smaller part of the issue of preserving its corporate tax, are nevertheless important.

Mr. ANDREWS. Thank you.

Mr. Chairman?

Chairman RANGEL. Thank you.

Mr. Spiegel, there is no question that you got this committee's attention as relates to the high-yield bonds, but on the question of the MLP's and the questions that were raised this morning—not so much as relates to equity financing, but more to the question of sound tax policy—do you think that we should have another option for losing revenue just because we've done such a poor job with the bond issues, junk bonds?

Mr. SPIEGEL. No, sir. I think we ought to get rid of one option, and that is to pay no tax at all, which is what's happening with corporate bonds. We talk about integration. You know, integration is a word that's used to say that on the corporate income there ought to be only one tax. That's the idea of integration. What's happening now is you've got integration compounded, because when the corporation raises its money with debt financing it integrates to the point where there's no tax collected. All I'm suggesting is that this committee ought to be more interested in collecting one tax for sure from limited partnerships than collecting two taxes in theory from corporations and getting none, in fact. And that's what's happening now.

Chairman RANGEL. If this committee was serious about changing the laws as relates to the master limited partnerships, do you believe that as much notice should be given as possible to the firms or to the businesses—

Mr. SPIEGEL. I certainly do. I certainly do. And I'll give you an example why. Several years ago a client that I have organized a publicly traded limited partnership. It cost us over \$140 million to do it. Now, that was at a time when we had to pay the tax on liquidation, before the *General Utilities* case. I think for this committee now—after that up-front tax had been collected and spent by the Government—to say "Now we're going to change the rules and treat you like a corporation," you know, is—I don't want to use "dirty pool," but it's approaching it, in my view. I think we ought to get a long, long time, or we ought to be grandfathered in and protected on that sort of thing.

Chairman RANGEL. Well, Mr. Spiegel, we're having these hearings in order to get these different views, but while we are delaying this, do you believe that those lawyers that agreed with you will be encouraging a corporation to create the MLP if they have situations such as the one that you brought before this committee, as opposed to going the corporate route? I mean, do you agree with Secretary Mentz that it's really not the revenue losses that we suffer in the short run, but there could be an erosion of the corporate structure as we know it and cause a great deal of lost revenue in the future?

Mr. SPIEGEL. You know, Roger Mentz said that as soon as he got out of the Treasury he was going to go out and organize MLP's like mad. I've been around that track. I was with the Treasury and now I'm out in the cool, cool world. Let me tell you, it isn't so easy to organize MLP's.

Let me give you just a couple of problems. You approach somebody and tell them you want them to be a general partner of a pharmaceutical company—a pharmaceutical company that's a limited partnership, and he begins to worry about his personal liability with a couple of billion dollars of Dalkon shield cases in his lap. You talk to people about being able to use debt when they have a limited partnership. It's very difficult to use debt when you have a limited partnership because when you have debt you've got to pay it back some time. To pay it back you've got to take your earnings and use them. The partners are taxed on those earnings—and they've got no income to pay the tax.

The fact of the matter is: it's not nearly as easy to organize and operate a limited partnership as you might believe. So I just don't believe that this is a growing cancer that's going to go by leaps and bounds. If you look at the actual facts—and I think that's one thing the committee could very profitably do: examine what has actually happened. Ed Oelsner, who follows me in one of these later panels, has done that. He's at Dean Witter, and they have looked at the kind of deals that are put together. Many of them are to replace existing debt, which I think is all to the good. Many of them are rollups of existing partnerships, where the Government doesn't lose any money—in fact, it makes some money on the rollup. Some of them are to raise new capital, as in the timber deal that I was talking about, where they've either got a choice of issuing bonds, or they've got to issue limited partnership interest.

None of those things are bad, in my view. And they talk about "Well, it's proliferating." The Boston Celtics—you know the Celtics were owned by three very wealthy individuals, a subchapter S corporation. Now it's owned by—I don't know—5,000. If they couldn't do this they'd have 35 millionaires if they wanted to get any bigger. But these are limited deals. How many other sports franchises have jumped into the water right away? I'm not saying there won't be some. I'm just saying you ought to stop, look, and listen, and take a look at what's actually happening in the real world and talk to some of the people who are trying to sell these partnerships, and you will find out that they're not—it isn't just a question of walking into somebody and say, "Let's convert this thing into a limited partnership and save a tax."

Chairman RANGEL. Well, Mr. Spiegel, I don't know whether it would help us just to go into the real world and talk with counsel that already have clients that are benefiting from this type of entity. It would seem to me that you would agree that if we're talking about tax policy, as opposed to what would be the best structure for a particular type of business, that the administration might be in a better position to be more objective as to what sound tax policy would be.

If, of course, there are certain businesses that would lend themselves to this particular structure—I think Secretary Mentz said that transition rules, or, for oil and gas certain exceptions could be made, and I don't think anyone could beat you in making the case for that entertainment outfit that you represent, but don't you believe that the administration has an obligation to set a set of rules that would not cause someone to pick and choose as to their tax liability, and not to say, as I think you're saying, is that no one's

going to select this route because the regulations are too complex? I mean, that's what, basically, you're saying, but you——

Mr. SPIEGEL. No.

Chairman RANGEL [continuing]. Haven't dealt with the question as to—you've dealt with the question that junk bonds are bad tax policy, but you haven't dealt with the question as to whether or not this particular type of partnership is good tax policy.

Mr. SPIEGEL. All right. Well, let me see if I can do it a little better than I have, then. We're agreed, I take it, at this point, that junk bonds are—it would be well if we could keep them from getting any more numerous than they are. It seem to me that's fairly sound tax policy.

Now, all I'm suggesting is: you haven't been able to come up with, and I haven't been able to come up with, any way to eliminate junk bonds. Interest is deductible, business interest deductible, and it's pretty hard to eliminate that. So if you just leave it the way it is, it seems to me you can anticipate that we'll continue to have the proliferation of junk bonds. I'm suggesting that there is an alternative way to raise capital, which is good tax policy, which will generate one tax at the individual level, and which will generate more money for the Treasury: namely, the issuance of partnership units in a roll out of corporate assets, as I described, in the entertainment industry or in the timber industry. I think that's good policy.

Now, you said, "Well, after all, you represent these people." I don't sell these entities, but the investment bankers do, and they're saying that Roger Mentz is a prophet of doom, that his prophecy is probably—and I don't impugn his motives—I just think that he overestimates the case and the facility with which these entities can be formed and operated, as based on 5 years of experience.

I mean, if we're as smart as we're supposed to be, and 5 years ago we were told there was a real fancy way to avoid taxes, do you think that we'd only have 100 of these things in the last five years with all the lawyers and accountants we've got around the country who were told that there's a good way to avoid taxes? We'd have had 10,000 of them if they were that attractive.

Mr. ANDREWS. One more thing, Mr. Spiegel. Are there any areas that we could change legislatively that maybe would assist us in compliance problems that we might have—that you might suggest?

Mr. SPIEGEL. I take it you're concerned with the compliance problem. I haven't mentioned that because I talked to our friends in the accounting fraternity, and I'm really staggered with the progress that has been made in developing proper methodologies for reporting proper K-1's to the partnership individuals and seeing it's done properly.

Now, I think you ought to cross examine Bill Nelson, who's your present chief counsel, you know. If he's satisfied that compliance is going to be all right you can quit worrying about it, because that's a very great concern of his. But I think that they've got it pretty well nailed down.

So, on the compliance problem, as I say, from what I've seen of it—I know in the partnerships I know something about, they've got a computer program that does the job well.

Mr. ANDREWS. Thank you. Thank you both.

We have a vote. Let's stand adjourned until 1:45.
[Recess.]

AFTERNOON SESSION

Mr. ANDREWS. On our panel this afternoon, we have: from Andrews & Kurth, Barksdale Hortenstine; from King & Spalding, William McKee; and from Brown & Wood of New York, Donald Turlington. I count four. Mr. Kuller, are you with King & Spalding?

Mr. KULLER. Yes, sir.

Mr. ANDREWS. Thank you.

Mr. McKee?

STATEMENT OF WILLIAM S. McKEE AND MARK A. KULLER, PARTNERS, KING & SPALDING

Mr. McKEE. My name is William McKee. I served as the Tax Legislative Counsel from 1981 to 1983 in the Department of the Treasury. My partner, Mark Kuller, served under me at the Tax Legislative Counsel's office, and then went on to become the Special Assistant to the Chief Counsel from 1982 to 1986.

Although our practice involves partnerships, we appear before you on behalf of no client, but only out of our interest in the tax policy issues that are under consideration before this committee.

Mr. Kuller and I participated in the Treasury's decision in 1983 to testify in favor of leaving master limited partnerships along. Mr. Kuller and I both believe that decision was correct when made, and continues to be correct now.

I want to make three short points—the day is long. First, Mr. Rangel asked, "What are the tax policy considerations in favor of leaving MLP's continue to be taxed under subchapter K?" It seems to me everyone acknowledges—and certainly the Treasury acknowledges—the evils of the double tax corporate system that we have. It is not sound tax policy. Why we want to take the only widely available, consistently applied, fully developed set of rules that provide a sound system of passthrough taxation, and make them unavailable to large enterprises, absolutely mystifies me.

The corporate tax system qualifies for Russell Long's maxim on the politics of taxation, which is "Don't tax him. Don't tax me. Tax the guy behind the tree." Nobody knows who pays the corporate tax, which is, I guess, why it's so politically popular. In fact, in the 1985 act—development of the 1986 act, the distribution tables that showed which classes of individuals were going to pay how much tax, we had a situation in which pretax corporate income was allocated among taxpayers, but no one was given credit for the corporate taxes paid, the excuse being that we don't know who really bears that burden. This gave us the absolutely wonderful result of a revenue-neutral tax bill that gave everybody a tax cut. That's why the corporate tax is unsound: it's a hidden tax that no one complains too loudly about because everybody thinks somebody else pays it. It's also an unsound tax.

I taught law for 13 years at the University of Virginia. I tried to teach my students that the fundamental goal of the Federal income tax system is to correctly measure each individual's income, make sure that it's taxed to the right person, in the right year, at the

right marginal rate. The corporate tax system fails badly on all counts. It gets the wrong people—we don't know who it gets—it clearly doesn't measure income correctly, and it doesn't tax anybody at the correct rate.

The second comment I'd like to make deals with comments made this morning on efforts to tinker with the classification rules. Once again, Mr. Kuller and I spent a lot of time while we were at Treasury dealing with this issue. When I arrived at the Treasury Department in 1981, there was a proposed regulation outstanding which would have made limited liability a super characteristic for purposes of determining entity classification. We spent 2 years struggling with that project, and eventually withdrew that reg at the end of 1982.

Our experience in trying to tinker with the classification regulations tells us that that is not a fruitful way to go. No matter what line you pick you will be accused of being arbitrary. The line that is currently drawn is arbitrary. It's a four-factor test. One could say instead of more than two maybe we ought to have less than two, or something else. My point is simply that there is no inherently logical point to pick. It's a continuum. The line that's picked right now is well understood. Our experience, as Government officials, indicated to us that it was well to leave that line where it sits.

My final comment deals with the corporate resemblance argument, which is a popular argument in favor of taxing MLP's as corporations. It's the "looks like a duck" argument: "looks like a duck, talks like a duck, quacks like a duck, must be a duck." Of course, no one has suggested that a two-person partnership is—although it looks just like a two-person corporation—ought to be taxed like a corporation.

So apparently we have a "looks like a big duck" argument—or some people might say a "turkey," which is what I suggest the argument really is.

My written testimony goes into some detail about the intellectual arguments behind the resemblance test, and the level playing field argument when you simply say that our analysis concludes that the level playing field is at least as well achieved by allowing MLP's to continue to exist. This point will be addressed in great detail tomorrow morning by Mr. Chapoton and Mr. Ballentine. I will leave to them—especially Mr. Ballentine, who was the Deputy Assistant Secretary for Economic Policy while I was Tax Legislative Counsel—and let him address that point in more detail.

I now turn the microphone over to Mr. Kuller.

Mr. KULLER. Thank you, Bill.

I, too, am pleased to have the opportunity to present my views to the committee. As we all know, the tax policy arguments in favor of integration, in general, and partnerships, in specific, are strong. With this in mind, money, or revenue, can be the only legitimate motive behind the Treasury's testimony. If MLP's will seriously threaten revenue, a case can be made for forsaking good tax policy in order to get the money.

Frankly, we dispute Treasury's revenue numbers, as well as their analysis. I think it is disingenuous for Treasury to come up here and suggest that there is some hidden revenue that cannot be

captured, that cannot be estimated. Those who have worked with revenue estimators know that if the revenue is there, it can be estimated.

Tom Vasquez, who was formerly the Chief Revenue Estimator at the Treasury Department, and Lyn Smith, formerly the Chief Revenue Estimator at the Joint Committee, have independently prepared revenue estimates on this issue which we can furnish the committee with.

Mr. Mentz claims that his revenue estimates are low. Mr. Vasquez and Mr. Smith, the two most experienced revenue estimators in the system, would say they're high. They conclude that, aside from the passive loss rules, classifying MLP's as corporations would lose money.

We think that the committee should view Treasury's estimates with some skepticism. Let me touch on three reasons for our view. First of all, there is the disincorporation argument. Disincorporation arguments have always been overblown. Forbes, which initiated the attack with the article "Disincorporated America," has published three subsequent articles, and only recently has started to back off of the disincorporation argument, suggesting that it's only a little problem. The 1986 act repealed *General Utilities*. There is very little, if any, disincorporation going on now and what disincorporation there is will increase revenues because of the tax on the liquidation of the corporation.

Compliance is another source of revenue concerns. Administrative and compliance problems are soluble. We will hear Coopers & Lybrand and Peat Marwick tell the committee that. Street name problems, which were a real problem, were solved by the 1986 act.

As to audit adjustments, we've heard suggestions today by the New York State Bar Association suggesting partnership level, collection of audit adjustments—we endorse that view. We think that's a good idea. In summary, compliance revenue concerns just aren't compelling.

Finally, let's talk a bit about the revenue implications of MLP alternatives. If MLP's are converted into corporations, corporate managers will have three alternative sources of capital: they will be able to issue debt, they will be able to issue new stock, or they will retain earnings to finance their investments.

Mr. Spiegel spoke eloquently about what would happen if we issued debt. Obviously the elimination of MLP's will result in further proliferation of corporate debt. We suggest this is undesirable from a matter of tax policy. At least in the MLP form one tax is paid. Where debt is involved, very often no tax is paid.

With respect to new stock as an alternative: there's no doubt that if companies choose to issue new stock instead of using MLP's there will be a revenue pickup, and that is the only revenue pickup in the whole spectrum that we can see, because there will be two layers of tax on the investment income instead of one layer of tax.

The third alternative is the use of retained earnings. We believe that this is a much more likely use than the use of new stock. Indeed, historical data published by the Federal Reserve Board shows that retained earnings are used by corporations six times as often as new stock is used to finance new corporate investment. If retained earnings are used to finance new corporate investment,

then there will be no dividend paid, or less dividends paid, and that will reduce the amount of dividend income subject to a shareholder level tax. The resultant reduction in revenues will more than offset any increase in revenues that comes about from the issuance of new equity.

We have included in our testimony a numerical example that illustrates these points, and as I said before we will be happy to furnish the committee with copies of the revenue estimates prepared by Mr. Vasquez and Mr. Smith that show—aside from the passive loss rules—that classifying MLP's as corporations will not pick up any revenue.

Thank you.

[The prepared statement of Messrs. Kuller and McKee follows:]

STATEMENT OF
WILLIAM S. MCKEE AND MARK A. KULLER
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES
JUNE 30, 1987

Mr. Chairman and Members of the Subcommittee:

Our names are William S. McKee and Mark A. Kuller. We are partners in the Washington, D.C. office of the law firm of King & Spalding. By way of background, Mr. McKee formerly served as Tax Legislative Counsel of the U.S. Treasury Department, has been on the faculty of the University of Virginia Law School and the New York University School of Law, and is the co-author of the leading treatise on the federal taxation of partners and partnerships. Mr. Kuller formerly served as Special Assistant to the Chief Counsel of the Internal Revenue Service and as attorney-advisor in the Office of Tax Legislative Counsel of the U.S. Treasury Department, and is currently on the faculty of the Georgetown University Law Center.

Although a significant part of our law practice is devoted to the representation of partnerships, we are not appearing on behalf of any client. Rather, we appear on our own behalf because of our interest in the tax policy issues under consideration by the Subcommittee at these hearings. We are privileged to have the opportunity to present our views on these issues.

The Subcommittee has identified four areas of inquiry: (1) The impact of the Tax Reform Act of 1986 (the "1986 Act") on the use of Master Limited Partnerships ("MLPs"); (2) The revenue effects of MLPs; (3) The application of existing Treasury regulations regarding entity classification to MLPs, and alternative classification proposals; and (4) The extent to which other permissible forms of partial integration should affect the tax classification of MLPs. We will discuss each of these matters in turn.

1. Impact of the 1986 Act

The partnership format, whether or not adorned with public trading, is currently an attractive alternative to corporate form for the same basic reason it always has been -- partnerships bear only a single level of taxation, versus the infamous "double tax" imposed on corporations. Moreover, two changes contained by the 1986 Act will further favor selection of

the partnership form as the tax-preferred form of business organization. First, the repeal of the so-called General Utilities doctrine^{1/} ensures that the double tax will in most cases be paid on income generated by corporate equity. Under prior law, a corporation could liquidate, or adopt a plan of liquidation, sell its assets, and then liquidate, and avoid most, if not all, of the corporate level tax on the appreciation in its assets.

Second, and more importantly, changes to the tax rate structure brought about by the 1986 Act make corporate equity investments relatively less attractive than similar investments in partnerships. Prior to the 1986 Act, the highest corporate rate of 46% was below the top individual rate of 50%. The corporate form thus offered a lower current tax burden on undistributed earnings and, when (and if) the second tax was eventually paid upon the shareholder's disposition of his interest in the company, the capital gains deduction substantially ameliorated the impact of the double tax. Under the 1986 Act, however, the highest individual rate of 28% is below the top corporate rate of 34%, such that the current tax burden is greater on corporations than partnerships. Moreover, the repeal of the capital gains deduction substantially increases the burden of the second tax on these earnings that must be paid when the shareholder disposes of his interest in the corporation.

While a reasonable case could be made under prior law for choosing the corporate form to minimize current taxes, build up the corporation's value over a period of years without any pressure to distribute earnings, and eventually dispose of its stock at capital gains rates,^{2/} the rate changes brought about by the 1986 Act dictate that the partnership form be chosen, with one major exception, whenever tax considerations are significant. The exception, however, swallows a substantial portion of the general proposition: whenever access to the capital held by the tax-exempt sector is important, the use of the partnership form will be severely restricted.

Placing operating businesses in partnership form creates severe problems for both tax-exempt and foreign investors. The unrelated business taxable income ("UBTI") rules of sections 511-

1/ General Utilities & Operating Co. v. Helvering, 296 U.S. 200(1935).

2/ Alternatively, the corporation could adopt a plan of liquidation, sell its assets, and liquidate. Under either approach, the General Utilities doctrine often further reduced the impact of the corporate double tax.

514 of the Internal Revenue Code^{3/} are designed to place tax-exempt entities on an equal footing with their taxable brethren when it comes to owning an interest in an operating business through a pass-thru vehicle. Historically, tax-exempt entities have shown an understandable aversion to paying taxes, and thus have avoided making investments that trigger UBTI. Assuming this remains true, since a large portion of the available investment capital in the United States is held by tax-exempt entities, most major business enterprises will continue to operate in the corporate form, and will avoid using the partnership form.

Similar considerations apply to foreign investors owning interests in partnerships. As partners in a partnership conducting a U.S. trade or business, they are deemed to be engaged in a U.S. trade or business^{4/} and thus are subject to taxation on their distributive share of the MLP's profits.^{5/} They must file U.S. tax returns,^{6/} and distributions to them are subject to withholding.^{7/} Foreign investors are thus an unlikely source of capital for partnerships engaged in operating businesses.

Nevertheless, we believe that partnerships, including MLPs, will absorb an increasing share of the Nation's investment capital as a result of the 1986 Act. Whether or not this is desirable from a tax policy standpoint is a matter of great debate. The Treasury Department itself has taken both sides of this issue, coming out in favor of MLPs in 1977^{8/} and 1983^{9/} and

3/ Except as otherwise noted, all section inferences in this testimony refer to the Internal Revenue Code of 1986, as amended.

4/ Section 875.

5/ Sections 871(b) and 882(a).

6/ Section 6012.

7/ Section 1446.

8/ Blueprints for Basic Tax Reform, Department of the Treasury (January 17, 1977).

9/ Statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Finance, United States Senate, Hearing on Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations, October 24, 1983.

against them in 1984^{10/} and 1986.^{11/} The issue is whether pass-through taxation is good or bad tax policy. The alternative is to impose a corporate tax on all enterprises that are denied access to a viable scheme of pass-through taxation.

Economists are virtually unanimous in their disparagement of the corporate tax.^{12/} The Treasury Department readily acknowledges its distortive effects and the desirability of its integration with the individual income tax system.^{13/} It's only saving grace is that it is a relatively easy tax to collect. Although corporations are legal fictions, many think of them as separate persons with taxpaying capacity. The corporate tax thus fits former Senator Russell Long's maxim of the politics of taxation: "Don't tax him, don't tax me, tax the fellow behind the tree!" Since corporations don't vote, they seemingly qualify for behind-the-tree status. Of course, some individuals must bear the corporate tax, but as long as most of us don't believe this, or believe that the burden is borne by someone else, the corporate tax will remain popular. Unfortunately, there is no such thing as a free lunch, and the corporate tax is no exception. While it is easy to collect because no one feels the pain of the tax burden, it is, as all serious students of tax policy know, an economically disruptive tax.

Berating the corporate tax, of course, smacks of beating a dead horse. Unfortunately, revenue constraints dictate that the corporate tax will be part of our tax system for the foreseeable future. The Treasury Department's 1984 tax reform proposal

10/ Tax Reform for Fairness, Simplicity, and Economic Growth, Department of the Treasury (November, 1984), noting the proposal in the context of significant integration of corporate and individual taxes.

11/ Statement of J. Roger Mentz, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, June 9, 1986.

12/ See C. McLure, Must Corporate Income Be Taxed Twice?, Brookings Institution (1979); G. Break and J. Pechman, Federal Tax Reform: The Impossible Dream? 90-104, Brookings Institution (1975).

13/ Statement of J. Roger Mentz, supra note 11; Blueprints, supra note 8.

included a modest effort towards integrating the individual and corporate tax systems by providing for a 50% dividends paid deduction.^{14/} The price tag of \$30 billion per year^{15/} was simply too high, and the proposal died.

In short, everyone seems to agree that the corporate tax is a bad tax, but that nothing much can be done about it because we need the money. Against this background, the debate about MLPs should focus on revenue considerations. If MLPs will seriously threaten revenue and thus materially increase deficits, a case can be made for taxing them as corporations -- forsaking good tax policy in order to "get the money." Conversely, absent revenue constraints, MLPs should be applauded as a slow step towards integration, an experiment in pass-through taxation in which administrability issues may be sorted out while the monetary stakes are small.

2. The Revenue Effects of MLPs

There are at least four distinct revenue issues that must be considered when examining the effects of MLPs: (a) The likelihood that corporate America will disincorporate, and, if so, its effect on the revenue; (b) The effect of MLPs on projected revenue from the recently enacted passive loss rules; (c) The degree of non-compliance in MLPs and its effect on revenues; and (d) The revenue effect of the likely alternatives to MLPs. We will discuss each of these issues in turn.

A. Disincorporation of America

The disincorporation of America through the proliferation of MLPs is a fear of both the press^{16/} and the Treasury.^{17/} To date, it hasn't happened; there are only about 100 MLPs in existence at this time. There are three principal reasons why the disincorporation concern is overstated.

14/ Tax Reform, supra note 10.

15/ This was the estimated revenue loss for fiscal year 1990. Id.

16/ One of the first articles on this subject, entitled "Disincorporating America," appeared in *Forbes* magazine in August, 1983. Similar *Forbes* articles were published in June and October of 1986 ("America, Disincorporated" and "Tax Reform's Tax Dodge"). Only recently has *Forbes* acknowledged that the movement is not as likely as first suggested in a December, 1986 article entitled "A Little Problem."

17/ Statement of J. Roger Mentz, supra note 11.

First, the corporate sector itself does not appear to be in favor of integration. This should come as no surprise. One of the chief tax policy problems with the corporate tax is its lock-in effect, but lock-in is a virtue from corporate management's prospective. By retaining earnings in corporate solution, the size and power of the corporation, and therefore its management, increases.

Second, as previously discussed, placing operating businesses in partnership form creates severe problems for both tax-exempt and foreign investors. Considering the dominant position held by these investors in the capital markets, it is highly unlikely that new and existing businesses will be willing to forego access to these major pools of investment capital.

Third, the cost of disincorporating is high. After the repeal of the General Utilities doctrine in the 1986 Act, the double tax is real. It must be paid as a toll charge for getting out of corporate solution. The issue is whether the current tax extracted by this toll charge will exceed the benefit of avoiding the double tax in the future. When quantifying this benefit, one must consider that a substantial portion of corporate earnings are not distributed currently; the second tax often is not paid until the shareholder disposes of his stock. Of course, each case requires separate analysis, since both the corporate and shareholder tax burdens of either liquidating currently or continuing to operate in corporate form depend upon a host of factors (the basis/value differentials at both the corporate and shareholder levels, the estimated future tax burdens on the enterprise if operated in corporate or partnership form, the estimated future date of liquidation or stock sale if the corporate form is retained, etc.). Nevertheless, we believe that in most cases, the current tax burden of liquidation will exceed the benefit of avoiding the slightly higher corporate tax on current earnings and the eventual second tax on the shareholder.

In summary, there is no evidence to indicate that there will be significant disincorporation of corporate America. Indeed, tax and business considerations dictate otherwise. Moreover, we are confident that any disincorporation that does occur will, at least in the short term, increase tax revenues. Thus, classifying MLPs as corporations would eliminate this potential, albeit small, source of revenue and, at least as far as disincorporation is concerned, reduce tax receipts over the next several years.

B. Effect of MLPs on the Passive Loss Rules

One feature of the new passive loss rules^{18/} will undoubtedly operate to produce a revenue loss from MLPs. Under those rules, income from a limited partnership interest goes into the "passive" basket, where it may be sheltered by passive losses. Dividends and interest, however, are portfolio income, which cannot be so sheltered. MLPs thus have the potential for converting portfolio income (the dividends and interest which would have been paid if the enterprise had been operated in corporate form) into passive income. Despite this benefit, to our knowledge, no MLP has been formed to take advantage of the passive loss rules and we doubt many MLPs would complain if the benefit was removed.

The Treasury has authority to treat income from MLPs as portfolio income,^{19/} but may be hesitant to do so because of the "heads-I-win, tails-you-lose" aspect of such a rule (*i.e.*, losses are passive, but income is portfolio). Congress may, of course, choose to preempt Treasury on this matter in order to capture badly needed revenue. In short, we concede that there may be a significant revenue loss from MLPs attributable to the passive loss rules. However, this revenue loss can and should be separately broken out. The tax classification of MLPs should not depend upon whether or not the Treasury or Congress plugs this hole in the passive loss rules.

C. Administrability and Compliance

It has been suggested that the administrability and compliance problems of MLPs will adversely affect the collection of tax. These concerns come in two flavors. The first is the sheer complexity of the partnership tax rules themselves. Mr. McKee has discussed the most significant of these complexities elsewhere^{20/} and we will not burden the Subcommittee with this technical tax minutia. Suffice it to say that most of these complexities can be simplified by the Treasury if it has the inclination to do so. It would thus be disingenuous for Treasury to raise concerns about complexity as the basis for condemning MLPs to the double-tax regime.

^{18/} Section 469.

^{19/} Section 469(k)(3).

^{20/} See Marich & McKee, "Sections 704(c) and 743(b): The Shortcomings Of Existing Regulations and the Problems of Publicly Traded Partnerships," 41 Tax L. Rev. 627 (1986).

The second concern is more serious: assuming each partner's tax consequence can be accurately measured, will the resulting tax be paid? A domestic partner's distributive share of partnership income is not subject to withholding, but, like interest and dividends, is only subject to information reporting.

To date, the most serious compliance issue in the MLP arena has been the lack of information reporting to street-name holders of MLP interests. Section 6031(c), as added by the 1986 Act, for the first time imposes a burden on nominees to provide tax information to beneficial owners and to provide information about the beneficial owners to MLPs. Although the 1986 Act did not impose a civil penalty on nominees for failure to comply with the requirements of section 6031(c), section 115(a) of the Technical Corrections Act of 1987 (H.R. 2636) would impose a \$50 penalty on a nominee for each such failure (up to a maximum penalty of \$100,000 per year). Assuming this technical correction becomes law, the penalty exposure should be significant enough to make the street-name reporting problem disappear.

The other compliance issue that merits consideration involves audit adjustments. Understandably, audit adjustments to tax returns of large partnerships are cumbersome to deal with because any adjustment must be reflected on what may be thousands of returns. Although the partnership-level audit rules enacted in 1982 provide a satisfactory set of rules for making and enforcing these adjustments, it may well be too expensive from the viewpoint of both the Internal Revenue Service and the taxpayer to make relatively small adjustments. Of course, this potential taxpayer expense traditionally has led to conservative tax reporting by MLPs, which is a clear plus for the fisc. Nevertheless, Congress should consider requiring the MLP to pay the additional tax. The tax would be calculated using assumptions about tax brackets most favorable to the fisc except to the extent the MLP could prove that a lesser bracket was appropriate (e.g., the MLP may know how many of its units are held by tax-exempt entities). The cost to the MLP of paying the tax may well be less than the cost of furnishing amended K-1's to its partners, and the fisc will be assured of getting its money.

D. Revenue Effects of MLP Alternatives

The so-called "dropdown" MLP is, and is expected to remain, the most widely used form of MLP. In today's environment, corporations employ the dropdown MLP principally as a means of raising capital to fund the acquisition of new assets or to retire debt. To raise this capital, the sponsoring corporation contributes (i.e., "drops down") assets to a newly formed MLP in exchange for a general partner's interest and limited partner interests. Thereafter, limited partner interests in the MLP are sold in an underwritten public offering by the MLP (in a non-

taxable "primary" offering) or by the sponsoring corporation (in a taxable "secondary" offering). This transaction does not result in the movement of value or net worth out of corporate solution. After formation of the MLP, MLP interests equal in value to the assets contributed are owned by the sponsoring corporation. Thus, to gauge the revenue effect of dropdown MLPs, one must compare the tax receipts that would be generated when new investment is financed by MLP equity with the tax receipts that would be generated by alternative sources of capital that would be used to finance new investment if MLPs were classified as corporations.

If MLPs were classified as corporations, corporate management would have three alternative sources of capital: (1) they could issue new debt (the "debt alternative"); (2) they could issue new stock (the "stock alternative"); or (3) they could retain more of the corporation's earnings by reducing current distributions to shareholders (the "retained earnings alternative").

The debt alternative is at worst, revenue neutral. In an MLP, the income generated by equity-financed operating assets would be subject to one level of tax -- at the partner level. Similarly, in the debt alternative, since a corporate debtor's income generally will be offset by interest deductions, the income generated by debt-financed operating assets also would be subject to only one level of tax -- at the creditor level.

The stock alternative would produce a revenue gain if substituted for an MLP. This is because the income generated by the assets financed with new equity ultimately would be subject to two levels of tax, as opposed to a single level of tax on MLP income.

The retained earnings alternative would produce a significant revenue loss if substituted for an MLP because corporate earnings which are not paid out currently would avoid a current shareholder level tax on dividend income. Of course, subsequent income from assets financed by retained earnings would be subject to a double tax, as compared to the single tax on MLP income. However, the additional tax revenue generated by the double tax would, at least in the short run, be dwarfed by the revenue loss sustained by the abatement of dividends. The following simple example should illustrate our point:

Example: X Corp wishes to obtain \$100 of capital to finance the acquisition of additional operating assets. Assume that the new assets will generate \$10 per year of income, X Corp is in the 34% bracket, and all other taxpayers are in the 28% tax bracket.

(i) MLP Alternative. Assume the \$100 is obtained through a primary offering by an MLP formed by X Corp. In this case, the \$10 of income generated by the new assets each year will be taxed only once, in the hands of the partners of the MLP. Over a subsequent five-year period, \$2.80 of tax will be paid each year.

(ii) Debt Alternative. Assume the \$100 is obtained through the issuance of \$100 of debt by X Corp, bearing interest at the rate of 10% per annum. In this case, the \$10 of income generated by the new assets each year will, as in the MLP alternative, be taxed only once, to the holders of X Corp's debt. X Corp will offset its \$10 a year operating income with a \$10 a year interest deduction. Over the five-year period, \$2.80 of tax will be paid each year. Thus, to the extent debt is used in lieu of an MLP, there will be no net revenue gain or loss.

(iii) Stock Alternative. Assume the \$100 is obtained through the issuance of new stock by X Corp, and that X Corp's policy is to distribute 100% of its current earnings (the assumption most favorable to the fisc). In this case, the \$10 of income generated by the new assets each year will be taxed once at the X Corp level (34% of \$10 = \$3.40), and again at the shareholder level (28% of 6.60 = 1.85). Over the five-year period, \$5.25 of tax will be paid each year. Thus, to the extent new equity is used in lieu of an MLP, there will be a \$2.45 revenue gain (\$5.25 less \$2.80) in each of the five years.

(iv) Retained Earnings Alternative. Assume the \$100 is obtained by X Corp by retaining \$100 of prior earnings. If X Corp was not compelled to retain its prior earnings, it would have distributed such earnings to its shareholders who would have paid \$28.00 in tax (28% of \$100) on the distribution. The remaining \$72.00 would have generated \$7.20 of income and \$2.02 of tax (28% of 7.20) each year. By funding X Corp's \$100 investment out of retained earnings, the tax burden on the income generated by the new assets will equal \$5.25 per year, as in (iii) above. Thus, to

the extent retained earnings are used in lieu of an MLP, there will be a \$24.77 revenue loss in year one (\$28.00 plus \$2.02 less \$5.25), and a \$3.23 revenue gain (\$5.25 less \$2.02) in each of years two through five.

This simple example demonstrates that (using assumptions most favorable to the fisc) if MLPs are not available as an alternative for raising capital (a) there will be no revenue impact if debt is substituted for the MLP, (b) there will be a revenue gain, in present value terms,^{21/} of \$9.78 if new corporate equity is substituted for the MLP, and (c) there will be a revenue loss, in present value terms, of \$13.03 if retained earnings are substituted for the MLP.

Thus, even if corporate managers choose the stock alternative as often as they choose the retained earnings alternative, a net revenue loss will occur. Moreover, statistics indicate that new corporate investment is financed with retained earning six times as frequently as with new equity.^{22/}

3. The Classification Rules

In 1960, the Treasury Department promulgated the current regulations under section 7701 to govern the classification of business organizations.^{23/} These regulations, like earlier versions, embody the "corporate resemblance" test originally set forth in Morrissey v. Commissioner, 296 U.S. 344 (1935), in which the Supreme Court identified what it believed to be the principal corporate characteristics. These characteristics are (i) associates, (ii) an objective to carry on a business or financial enterprise and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) limited liability, and (vi) free transferability of interests. The principle difference between the 1960 regulations and its predecessors is that the 1960 regulations contain a numerical supremacy test that requires more corporate than non-corporate characteristics to be present before corporate classification results, and are thus biased against corporate classification.

21/ Using an 8% discount rate over the five-year period.

22/ See Flow of Funds Accounts, Second Quarter of 1986 (and earlier issues), Sector Statements of Savings and Investment, Board of Governors of the Federal Reserve System, Washington, D.C.

23/ See Treas. Reg. § 301.7701.

The Treasury Department has, for the most part, left the 1960 regulations unchanged for the past 27 years. However, during that period and, in particular, during the past 10 years, there have been numerous attempts to modify, in some form or another, the classification rules. Virtually all of these attempts were ultimately aborted. Let us briefly review these attempts.

A. The 1977 Proposed Regulations

Early in 1977, the Treasury Department proposed new regulations that would have substantially altered the standards utilized in distinguishing partnerships from corporations, and eliminated the bias in the regulations against corporate classification. Bowing to heavy criticism, the Proposed Regulations were promptly withdrawn.^{24/}

B. President Carter's Proposals

In January 1978, President Carter proposed that any newly formed limited partnership with more than fifteen limited partners be taxed as a corporation, unless substantially all (i.e., more than 90 percent) of assets consisted of subsidized low-income housing.^{25/} Congress gave this proposal what it deserved -- short shrift.

C. The Proposed Limited Liability Company Regulations

In 1980, Treasury issued proposed regulations that would have automatically classified an organization as a corporation for tax purposes if under local law no member of the organization was personally liable for debts of the organization.^{26/} Specifically, the proposed regulations were aimed at classifying Wyoming limited liability companies as corporations.

24/ Prop. Treas. Reg. §§ 301.7701-1 through 301.7701-3, 42 Fed. Reg. 1038 (Jan. 5, 1977), withdrawn, 42 Fed. Reg. 1489 (Jan. 7, 1977).

25/ See Staff of Joint Committee on Taxation, 95th Cong., 2d Sess., Summary of the President's 1978 Tax Reduction and Reform Proposals 6 (Comm. Print 1978).

26/ Prop. Reg. §§ 301.7701-2(a)(2), 301.7701-2(a)(3), and 301.7701-2(a)(4) (1980).

Treasury withdrew the proposed regulations in 1982,^{27/} stating that it would undertake a study of the classification rules with a focus on the significance of the characteristic of limited liability. To date, the Treasury has not announced any results of this purported study.

D. Finance Committee Staff Proposals-

In 1983, the Senate Finance Committee Staff's preliminary report on Subchapter C contained a proposal that would tax as a corporation any limited partnership with interests traded on an established securities market.^{28/} The report stated that large, centralized business organizations ought to be subject to an entity tax because of their similarity to large corporations. The Treasury Department, testifying on the preliminary report, opposed the Staff's classification proposal and it was deleted from the staff's final report.^{29/}

E. Treasury's Tax Reform Proposals

In November 1984, the Treasury Department released the so-called Treasury I report, detailing its proposals for tax reform.^{30/} One of these proposals was to tax as corporations limited partnerships with more than 35 limited partners. The Treasury based its position principally on a corporate resemblance argument, stating that large limited partnerships offer many of the investment and legal characteristics of a corporation and should thus be taxed as such. Six months later, in May 1985, the President's official tax reform proposal, as prepared by the Treasury Department, was submitted to the Congress without any mention in it of the 35-partner proposal.^{31/}

27/ I.R. 82-145 (Dec. 16, 1982).

28/ The Reform and Simplification of the Income Taxation of Corporations, Preliminary Report of the Staff of the Senate Finance Committee (1983).

29/ The Subchapter C Revision Act of 1985, A final Report Prepared by the Staff of the Committee on Finance, United States Senate, S. PRT. 99-47, May, 1985.

30/ Tax Reform, supra note 10.

31/ The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985).

F. Treasury's 1986 Testimony

It was against this backdrop that the Treasury Department, in June 1986, testified in favor of taxing publicly traded partnerships as corporations.^{32/} Treasury made three principal arguments in support of its proposal. First, it cited the administrative and audit problems of large partnerships. Second, it identified certain non-tax business uncertainties, complexities, and risks associated with operating in partnership form, stating that "[t]he inefficiencies borne by an entity and its owners are not irrelevant to the choice of appropriate tax rules." Third, it focused on corporate resemblance contending that publicly traded partnerships behave like corporations in all material respects and, thus, to tax them differently would both raise questions of fairness and challenge the integrity of the corporate tax base.

We have previously addressed the administrability/compliance issues and we decline to dignify the Treasury's second argument with a response. It is, however, worth discussing corporate resemblance.

When examined under the current section 7701 regulations, virtually all MLPs are classified as partnerships for tax purposes; MLPs typically possess free transferability of interests and centralization of management, but lack continuity of life and limited liability. Apparently, the Treasury Department now believes that public trading of interests should be treated as a dominant characteristic in classifying state law partnerships as corporations for tax purposes. Treasury's basic pitch is that if a partnership issues publicly traded interests, it should be taxed as a corporation because it looks like a corporation. As the old saying goes, if it looks like a duck, walks like a duck, and quacks like a duck, it must be a duck. We submit that this "looks-like-a-duck" argument is devoid of intellectual content. No one argues that non-traded corporations and non-traded partnerships have less in common than publicly-traded corporations and publicly-traded partnerships, yet no one suggests imposing a corporate tax on non-traded partnerships. It is thus better phrased as the "looks like a BIG duck" argument. Or perhaps a turkey, which more closely resembles the argument itself.

Public trading of interests is an extrinsic characteristic of an entity that has nothing to do with the relationship of the owners to each other or to the entity. A partnership is no less a partnership because its interests are bought and sold just as a public corporation is no less a corporation when its stock ceases to be traded. If trading is so

^{32/} Statement of J. Roger Mentz, supra note 11.

critical to entity classification, would Treasury, in its new classification regime, support relieving all non-traded, privately held, corporations from a second level of tax? If for no other reason than revenue, the answer is emphatically no. What this then boils down to is yet another "heads I win, tails you lose" rule. Such rules are always hard to justify. In the passive loss area, such a rule is tolerable only because of the revenue stakes involved. But, as we previously have discussed, aside from the revenue loss attributable to the passive loss rules, classifying MLPs as corporations is likely to lose revenue. What then could justify such a rule?

The duck argument really breaks down into two quite disparate propositions: (1) all business enterprises should be subject to two levels of tax, subject perhaps to a "small business" exception; and (2) even if the corporate tax is not sound, it is a permanent feature of our tax landscape, and MLPs must be taxed as corporations to ensure a "level playing field." The merits (or lack thereof) of a two-tier tax are discussed above. Suffice it to say that not even the Treasury Department, in its testimony against MLPs, was willing to argue that the two-tier tax should be the norm and pass-through taxation the exception, although the Treasury acknowledged that this proposition is consistent with taxing MLPs as corporations.^{33/}

The level-playing-field argument has more substance. In essence, the proposition is that a tax, no matter how poorly conceived, either should be extracted from all similarly situated individuals, or be repealed. Since we are not about to repeal the corporate tax, and since owners of MLPs and publicly-traded corporations are similarly situated, they both should be subject to the same two-tier scheme of taxation.

The rebuttal to this argument is that unless the Treasury (and Congress) is willing to level the entire field, either by fully integrating the system or by imposing a double tax on all business activities, its proposal is akin to excavating dirt from one part of the field to level off another part. If MLPs are taxed as corporations, the partnership playing field would no longer be level. Small investors who have access to MLPs, but not to private partnerships, would be seriously disadvantaged as compared to wealthy investors.

We readily admit that the section 7701 regulations are not perfect. However, making public trading a dominant characteristic is no more a solution than was the attempt in 1980 to make limited liability a dominant characteristic. Our personal experience, as government attorneys, indicates that neither the

33/ Statement of J. Roger Mentz, supra note 11.

Treasury nor the Congress will be able to devise a more sensible or fairer set of classification rules than those contained in present law. History confirms our belief that efforts to modify the classification rules will be unproductive. The existing rules are well understood by most practitioners and have not caused a revenue hemorrhage.

4. Other Forms of Integration: The Debt Alternative

Because of the substantial tax burden imposed on corporate equity under the existing tax system, corporations are compelled to rely heavily on debt since its cost -- interest -- is fully deductible and thus reduces corporate level taxes. Considered in this light, the MLP alternative for raising capital should be compared to the debt alternative, not to the stock alternative. MLPs offer business managers an equity alternative to corporate debt. Since MLPs offer no tax advantage over corporate debt, the MLP alternative typically will be chosen solely for sound non-tax business reasons.

There are several business reasons why corporations would prefer to raise equity capital through an MLP in lieu of borrowing: (1) MLP distributions need not be made on fixed due dates, as typically is the case for payments of principal and interest; (2) MLP equity does not appear as debt on the balance sheet of the corporate sponsor of the MLP; (3) MLP equity does not impose any restrictive lending covenants on the corporate sponsor of the MLP; and (4) corporations can go bankrupt if their income is insufficient to pay their debts as they come due, but will not suffer a similar fate merely because the MLP is unable to make a contemplated cash distribution to its partners.

Considering the strong concerns that have been expressed regarding leveraged buyouts and the proliferation of corporate debt, Congress should think long and hard as to whether the United States economy is well served by denying businesses the ability to raise capital by selling partnership equity when the most cost-effective alternative is to issue even more corporate debt.

5. Summary

A. The tax policy arguments in favor of partnership taxation in general, and MLPs in particular, are strong.

B. The 1986 Act is likely to increase the use of partnerships.

C. Aside from the passive loss rules, classification of MLPs as corporations is likely to lose revenues.

D. Problems with the tax administrability of MLPs are soluble.

E. The Treasury's looks-like-a-duck argument is intellectually unsound and should be rejected.

F. Wholesale revision of the existing classification regulations would be unproductive.

G. Elimination of MLPs will spawn increased use of corporate debt.

STATEMENT OF BARKSDALE HORTENSTINE, PARTNER, ANDREWS
& KURTH

Mr. HORTENSTINE. My name is Barksdale Hortenstine. I'm from the Houston firm of Andrews & Kurth. I want to thank you for allowing me to appear before you to express my views.

Andrews & Kurth has been fortunate enough to participate in the first corporate-sponsored MLP, and has participated in over a third of the MLP's done since that day. We're very aware of our proprietary interest in the entity classification issue and have no reason to hide it; however, I think more importantly we are in a position to provide some valuable insight as to exactly why corporate sponsored MLP's are being done.

Frankly, with all due respect to Secretary Mentz, what we heard this morning was the same story we heard last year. It shows absolutely no awareness of what has transpired in the market place with MLP's. In addition, Mr. Mentz' testimony contains several inaccuracies, a few of which I'll point to in this oral testimony.

The fact is: MLP equity is being used as a substitute or replacement for corporate debt. Although MLP equity entails a slightly higher cost of capital than debt, corporate managers are more than willing to incur that higher cost of capital in order to receive the benefit of operating free of the risk of default.

When there is MLP equity, if an MLP sponsor misses a distribution to its partners, it may make the partners mad; but the sponsor does not, however, have to worry about those partners bankrupting the MLP as he would unpaid creditors.

The entities that are forming MLPs are entities that are not in financial distress, but are overleveraged from previous acquisitions or restructurings, and are looking for a way to lay off that debt, convert it into a fairly inexpensive form of equity, and yet have a full valuation of their assets. That is exactly what the MLP provides them. It provides them the highest and best value for their assets so they suffer the least dilution by selling equity, and yet are able to operate free of the risk of default accompanying an issuance of debt.

We have not done one MLP to date where corporate equity was even an alternative consideration. The investment bankers, including Ned Oelsner who is testifying today, will tell you why corporate equity is such an expensive source of capital. Presently, MLP equity is the only realistic alternative to the use of debt available to a corporate sponsor.

Economists and policymakers alike will agree that there is an inherent bias built into the corporate tax system favoring debt over equity, simply because interest is deductible and dividends are not. That bias drives management to create value—or attempt to create value—through the capitalization of tax savings resulting from the shelter provided by the interest deduction. This is why you see new announcements of LBO's and leveraged recapitalizations every day you pick up the newspaper. The business behavior that results from corporate sheltering through debt is a continual churning of assets in order to generate cash to service the debt. A distortion of business behavior results from overleveraging of corporations in

that corporate managers are forced to disregard economic considerations in order to continue to service their debt load.

In every business article you read nowadays there are repeated warnings from economists that the slightest economic downturn could have a devastating impact on the economy as a whole due to the present excessive levels of debt in the corporate sector.

Living in Houston is a good example of what overleveraging has done to the oil and gas and real estate industries there. Countless bankruptcies, plant closings, unemployment, destabilization of savings and loans and smaller banks, a general decline in the standard of living, and a very slow recovery, all due largely to the overleveraging in those industries.

On the one hand Treasury asserts support for integration; on the other they propose to eliminate the only free market vehicle that is an alternative to debt simply because it is an imperfect ad hoc or half loaf form of integration, knowing full well that the chance of ever integrating the corporate tax system as a revenue matter is for the most part nonexistent.

In defense of their position they cite the fear of disincorporation. There are basically two forms of disincorporation. First, the overt form where you convert an existing corporation to an MLP. I think everyone agrees, including Treasury, that with the 1986 act repeal of *General Utilities* the tax cost of effecting such a conversion cannot be justified under an economic analysis; therefore, it's not a real threat. Second, the more subtle form is the movement of future business entities that are accessing the public capital markets for the first time from corporate form to partnership form.

Fear of wholesale avoidance of the corporate form in accessing public capital seems unwarranted in that there are several things publicly traded partnerships cannot do that publicly traded corporations can do. One, such partnerships cannot access either institutional or foreign equity. The UBIT rules and other technical rules in the code allow very little, if any, access to such sources of equity. As far as their access to institutional debt, MLP's historically maintain much lower levels of debt than public corporations. There is no indication that this trend will change in the future. At most, the highest level of debt is maintained by the acquisition of MLP's today, at a level of about 50 of total fair market value capital. On the other hand, in the highly leveraged corporate LBO's, corporations are maintaining 90 and 95 percent levels of debt to total fair market value capital. There is absolutely no comparison, and there is no truth to the statement in Mr. Mentz' testimony that MLP's are maintaining higher and higher levels of debt, comparable to the debt levels found in the corporate sector. I firmly disagree with such a statement.

The strict distribution policy that the marketplace imposes on MLP's is usually not acceptable to most corporate managers. Such managers much prefer the unlimited reinvestment discretion that they enjoy under the corporate forum.

The point of the matter is that I just don't see the potential for this massive disincorporation and hemorrhaging loss of corporate sector revenue. I don't see General Motors, Chrysler, United States Steel, or any other capital-intensive or growth-oriented business moving into the MLP's form.

As far as the revenue impact is concerned, I have to agree with Mr. Kuller that MLP equity, which is subject to one-tier tax, is replacing corporate debt, which is, at most, subject to one-tier tax. It is not replacing corporate equity, which is subject to two tiers of tax. So it baffles me how there can be any revenue loss under the present system of classifying MLP's as partnerships other than that attributable to the conversion of what would otherwise be portfolio income under the corporate form to passive income under the MLP form.

My recommendation would be that you abandon the attempt to reclassify MLP's as corporations, and you, instead, reclassify MLP income as either portfolio income or income other than passive income. I think there's more revenue in that issue for Congress.

[The prepared statement of Mr. Hortenstine follows:]

**STATEMENT OF BARKSDALE HORTENSTINE
BEFORE THE
HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HEARINGS ON MASTER LIMITED PARTNERSHIPS**

June 30, 1987

My name is Barksdale Hortenstine. I am a practicing attorney and a member of the law firm of Andrews & Kurth, Houston, Texas. I am appearing here today as a member of that firm, but not on behalf of any client. Andrews & Kurth has been involved in the formation of approximately one-third of the existing master limited partnerships ("MLPs") formed to date.

The stated purpose of these hearings is to analyze the appropriate classification of MLPs in the context of the Tax Reform Act of 1986 (the "1986 Act") and the changes in taxpayer behavior that have resulted or will result from its passage. I will direct particular attention to the risk that projected revenue collections from the corporate sector will be diminished as a result of the treatment of MLPs as pass-through entities.¹

There are two conclusions reached in this testimony that should be emphasized at the outset:

1. There appears to be little, if any, risk that the pass-through treatment of MLPs will prompt a reincorporation or other realignment of the public company arena from the corporate organizational form to the partnership form.
2. MLP equity has been used by corporations as a replacement or substitute for debt. As a result, pass-through treatment of MLPs does not result in a revenue loss to the federal government. The prudent course, from both a policy and revenue perspective, would seem to be a reclassification of MLP income as other than passive income rather than a reclassification of the MLP entity itself.

**ECONOMIC AND FISCAL
POLICY CONSIDERATIONS**

Impact of the 1986 Act. The common perception exists that certain provisions of the 1986 Act have the effect of strongly encouraging the reincorporation of existing entities and compelling the use of noncorporate forms for conducting future business activities. Many view the 1986 Act rate structure itself as fostering the use of pass-through vehicles. For several reasons, however, comparisons of the theoretical maximum rates may be misleading.

A fully distributed dollar is affected only marginally by the 1986 Act rates. After phase-in of these rates, the maximum effective tax rate on a corporate shareholder's distributed dollar is 52.48%.² The maximum effective tax rate on a partner's distributed dollar is only 28%. This is a difference of 24.48%. Previously, the rate differential between the distributed corporate and partnership dollar was 23%.³ Thus, the effect of the new rate structure on the distributed dollar is a widening of the differential by only 1.48%.

The impact of the 1986 Act on a fully reinvested dollar is more significant. This impact results primarily from the elimination of the capital gains preference. As in the case of the distributed dollar, the differential between the tax rate on a corporation's reinvested dollar and a partnership's reinvested dollar is 24.48%.

¹ With the principal focus of this testimony being the erosion of the corporate tax base, references herein to MLPs are intended to refer to corporate sponsored MLPs formed through a nontaxable contribution of assets, unless otherwise specifically noted.

² Corporate dollar: $\$1 \times 34\% = 34\%$; $66\% \times 28\% = 18.48\%$; $34\% + 18.48\% = 52.48\%$.
Partnership dollar: $\$1 \times 28\% = 28\%$. Differential: $52.48\% - 28\% = 24.48\%$.

³ Corporate dollar: $\$1 \times 46\% = 46\%$; $54\% \times 50\% = 27\%$; $46\% + 27\% = 73\%$.
Partnership dollar: $\$1 \times 50\% = 50\%$. Differential: $73\% - 50\% = 23\%$.

Previously, because of the preferential capital gains rate, this differential was only 6.8%.⁴ Thus, the effect of the new rate structure on the reinvested dollar is a widening of the differential by a significant 17.68%.⁵

The argument that the 1986 Act rate structure will alone have a significant impact on taxpayer behavior has clearly been overstated, at least as applied to the publicly traded entities. The differentials based on actual effective tax rates are substantially less since few, if any, public corporations pay taxes at maximum rates.⁶ Moreover, corporations generally distribute only a small percentage of net corporate earnings, while partnerships, especially MLPs, distribute most, if not all, of their net cash flow. Since the actual differentials based on effective rates may not be significantly changed by the 1986 Act, it follows that the rate structure should not be considered a compelling influence to disincorporate in the public capital markets.

In addition to the increased rate differentials between corporate shareholders and partners that result from the flip-flop in rates and the repeal of the capital gains preference, however, the repeal of the *General Utilities* doctrine imposes an additional tax burden of significance on the corporate structure. Such repeal ensures that asset appreciation in corporate solution will be taxed at the combined maximum rate of 52.48% (rather than the single 20% rate applied to a shareholder under prior law).

Lastly, the "book income" preference for purposes of the corporate minimum tax is often noted as providing significant pressure to disincorporate.

With the changes in rate structure, the repeal of *General Utilities* and the book income preference, the use of the corporate form can entail substantial tax cost. Thus, concerns over "corporate flight" are warranted—especially in the private capital markets where the use of the partnership and S corporation forms involve few significant restraints. The issue is whether the same concerns are warranted in the public capital markets.

Economic Policy Under the Corporate Tax System. There appears to be general agreement among economists and policymakers that the corporate tax system has little value. It does produce tax revenues, however. Economically, the two-tier tax discriminates against those activities traditionally conducted in corporate form. It clearly increases the cost of equity capital to the corporation and, as a result, may reduce levels of output in the corporate sector. In addition, avoidance of the two-tier tax often drives corporate management to use cash flows in an economically inefficient manner in order to maximize tax efficiencies. The result is often a dedication of cash flow to tax sheltering, a reinvestment policy emphasizing earnings with little regard to economic yield and other activities which diminish the capacity and desirability of dividends. This inefficient reinvestment policy can only be justified on a tax efficiency basis. By providing management with such reinvestment incentive, the corporate tax is promoting a misallocation of resources.⁷

Perhaps more importantly, the imposition of a two-tier tax promotes the funding of corporate activities with debt capital rather than equity capital, by allowing the deduction of interest but not dividends. At the corporate level, the income generated from the use of debt capital is offset, for the most part, by interest deductions. Thus, the most tax efficient source of capital in the corporate sector is the debt market. At the creditor level, interest income is subject to taxation only if the creditor is a taxable person and then only at the creditor's effective rate. It has historically been the case that corporate debt is held predominantly by non-taxable persons or those who have very low rates. Accordingly, corporations are encouraged to use the one source of capital which is serviced by corporate income that goes largely untaxed. That this results in a substantial revenue loss to the government cannot be refuted.⁸

⁴ Corporate dollar: $\$1 \times 46\% = 46\%$; $54\% \times 20\% = 10.8\%$; $46\% + 10.8\% = 56.8\%$.
Partnership dollar: $\$1 \times 50\% = 50\%$. Differential: $56.8\% - 50\% = 6.8\%$.

⁵ This analysis assumes that a corporate shareholder ultimately realizes the economic value of the reinvested earnings on the sale or liquidation of his stock.

⁶ It has been estimated that the actual corporate tax rate of large corporations approaches only 15%.

⁷ This testimony assumes that even with the 1986 Act's elimination of capital gains (a significant reinvestment incentive) corporate management will continue to hoard after-tax earnings in quenching its thirst for capital and investment power. Postponement of the dividend tax and sheltering of the corporate tax will likely continue to serve as its excuse to shareholders.

⁸ For example, an LBO will utilize that amount of debt, and no more, necessary to eliminate corporate level taxes and that debt will likely be held by tax-exempts.

The debt incentive inherent in the corporate tax regime also distorts business behavior by providing tax benefits that will often make assets more valuable in the hands of an acquiring corporation than in the hands of the present corporate owner. This induces corporations to transfer their assets to other corporations, regardless of economic considerations. The resulting enhancement of asset values is attributed solely to a capitalization of the tax savings arising from the conversion of corporate equity to debt. Once this pyramiding of value is set in motion, a churning of the assets and debt usually follows. Each leveraged acquirer will seek to realize on its investment and relieve itself of the severe debt obligations. Many attribute the recent surge of leveraged buy-outs and corporate debt recapitalizations almost exclusively to the presence of an unintegrated corporate tax system which allows an unlimited deduction for interest on debt.

Any expansion of the corporate tax regime (such as to MLPs) can only accelerate the current trend of corporate management to rely on debt as a primary source of capital with the associated loss of revenue and economically distorted business behavior. Moreover, corporate overleveraging greatly undermines the economic stability of the corporate sector and, perhaps, the economy as a whole.⁹

Economic Policy Under the Pass-Through Tax System. Against this backdrop of the economic policy evils attendant to the corporate tax, the integrated or pass-through regime is most refreshing. Since MLPs are free of the influence of debt incentives, they have provided corporate managers an efficient means for raising equity capital as either a replacement for existing debt or a substitute for future debt. As capital raised through an MLP is generally in the form of equity, the opportunity for long term economic stability in both the business sector and the economy as a whole is enhanced. By replacing debt with a minority equity interest, the corporation creating an MLP has substantially improved its debt to equity ratio and enhanced its credit rating. From a tax revenue perspective, the use of MLP equity as a replacement or substitute for debt may well be a benefit since at least one level of taxation will be imposed on the income of the organization.¹⁰ In fact, most MLPs formed to date have been used by corporations to repay or avoid corporate debt. It is estimated that 95% of the cash proceeds raised through MLP equity offerings was used by either the corporation forming the MLP or the MLP itself to retire, or avoid the incurrence of, corporate debt.

Significantly, MLP interests are structured as yield-oriented investments. Both the marketplace and analysts assess the strength of an MLP's performance on the ability to sustain relatively high cash distribution levels. Without the excuse to avoid dividends provided by the two-tier tax, managers of MLPs are subject to significant restraints imposed by the marketplace on their ability to reinvest cash flows. These restraints dictate that an MLP only reinvest when the reinvestment is consistent with the limited purpose for which it was originally formed. This reinvestment can only be justified to unitholders if nondilutive from a cash flow perspective. The demand for cash distributions leads to a responsiveness to owners unlike that of corporate management. In short, because MLPs are not afforded the tax bias for reinvestment under their current system of taxation, capital flows to those areas producing maximum economic gain.

Lastly, MLPs provide small investors an opportunity to invest in a limited scope entity free of conglomeration and free of the volatility of a stock market dominated by institutions. The MLP has therefore tapped an unused source of investment capital and extended to the nonwealthy benefits of direct investment previously available only to the wealthy. It is not surprising, therefore, that the most frequent purchase of MLP interests is around 200 Units - - from \$2,000 to \$4,000. It seems as if the smaller investor is taking advantage of this opportunity.

Fiscal Policy. Despite the many deficiencies in the corporate tax system, budgetary constraints prohibit an integration of the system and dictate its preservation as a source of revenue. Given that starting point, can MLPs be allowed to survive?

The 1986 Act shifted \$120 billion of the federal tax burden from the individual sector to the corporate sector, over a period of five years. This has the effect of boosting corporate tax revenues to 12 1/2% of total federal receipts. In its

⁹ The regional impact of excess leverage is well illustrated by the slow pace with which the economy of the oil producing states is recovering despite the partial recovery of oil prices. Quite simply, leverage levels predicated on crude prices of at least \$30 per barrel cannot be serviced with crude prices hovering at \$18 per barrel, without substantial disruption of operations.

¹⁰ As will be discussed, for various reasons MLP interests are almost exclusively sold in the retail market to nonpaying individuals while the corporate debt market is dominated by institutions that pay little or no taxes.

present budget reconciliation, Congress is searching for another \$65 billion in tax revenues over a three year period. Faced with fiscal pressures of this magnitude, Congress is often forced to forsake sound economic and tax policy in the interests of short term revenue enhancement. Thus, if MLPs substantially erode the corporate tax base or otherwise threaten corporate sector revenue, this Committee might on that basis justify corporate classification of such entities.

MLP CONCERNS

Representatives of the Treasury Department and other advocates of classifying MLPs as corporations generally voice three primary concerns: (1) MLPs will cause the disincorporation of the corporate sector, resulting in substantial revenue loss; (2) MLPs so closely resemble publicly held corporations that fairness dictates they be taxed as corporations (to establish a "level playing field"); and (3) MLPs impose such significant administrative problems that the problems can only be solved by eliminating the entity. The first two of these arguments will be addressed at length in this testimony. To propose that classification of MLPs turn upon administrative concerns would appear so unreasonable, especially in this advanced age of computer technology, as to merit little consideration.

LOSS OF REVENUES

Disincorporation

There are two types of disincorporation. The more obvious is the conversion to noncorporate form of an existing corporate business through a liquidation. A less obvious form of disincorporation is the failure to incorporate a business that would have been incorporated, absent the availability of the MLP form. Conversion of an existing corporation to an MLP may involve an immediate reduction in the corporate tax base. A failure to select the corporate form, however, involves either a long term loss in growth of the corporate tax base or a long term failure to replace that portion of the corporate tax base eroded by attrition (business failures, stagnation or liquidation).

Existing Corporations. The movement of assets from the existing corporate sector into the pass-through sector can occur in several ways. This movement ranges from the outright liquidation of an existing corporation into an MLP ("Liquidation MLP") to the contribution of assets of an existing corporation ("Sponsor") to an MLP, with the Sponsor surviving such process ("Dropdown MLP"). Only the liquidation of an existing corporation, however, would constitute a disincorporation entailing an erosion of the corporate tax base.¹¹

This testimony will address a number of substantial disincentives to operating in partnership form. These disincentives impact both existing and future businesses. Before doing so, however, it must be emphasized that, as a result of the repeal of *General Utilities*, the tax cost of converting an existing corporation to an MLP has been significantly increased. Generally, a corporation will be taxed upon liquidation as if it sold its assets for fair market value at the time of such liquidation. The shareholders will then recognize capital gain on the liquidation. The same result obtains upon a dividend of assets out of a corporation except that the income to the shareholders will be ordinary in nature. The two-tier tax which results in both cases is likely to be so substantial as to deter any liquidation (and most dividends) of assets out of corporate form into partnership form. Importantly, the tax revenues accelerated as a result of a fully taxable liquidation will be recouped through basis utilization (via depreciation or amortization) only over a substantial period of years, if at all.¹²

Similarly, an MLP which has been formed to acquire corporate assets ("Acquisition MLP") will accelerate federal tax revenues -- revenues resulting from the sale of the Sponsor's assets. In addition to the acceleration of future tax revenues, the transaction will also result in greater tax revenues than would have been triggered on a sale of the same assets to another corporation. The value placed by an MLP on assets will typically be greater than that which a corporation would place on the same assets, due to the purer form of economic ownership that the MLP provides the public. As a result, the seller recognizes an increased taxable gain on the sale. Additionally, any

¹¹ At best a piecemeal form of disincorporation, the same effect of disincorporation exists if the Sponsor distributes some or all of its MLP interests as a dividend or in a partial liquidation or other redemption of stock.

¹² Notably, any liquidation of a corporation engaged in an ongoing business will involve nondepreciable assets such as goodwill, particularly under the newly required residual allocation method. Furthermore, the depreciable lives of most assets were increased under the 1986 Act such that the present value of a stream of depreciation has been significantly reduced.

corporate purchaser would likely be highly leveraged in an attempt to maximize tax efficiencies.¹³ As noted earlier, this debt would likely be held predominantly by tax-exempt institutions, with little or no tax paid on the income servicing the debt. Since substantially all MLP interests are owned by individuals, at least one level of tax would be paid on the yield servicing the MLP's equity. Moreover, the proceeds from the sale will either be dividended to shareholders or will remain in corporate solution to be reinvested. Either will generate additional revenues in the form of a dividend tax or in the form of corporate taxes on income from the reinvestment. Certainly no loss in tax revenues can result.

The Dropdown MLP formed by a Sponsor's contribution of assets to a partnership followed by a sale of a minority interest to the public, involves no movement of assets out of corporate solution. The Sponsor has the same asset value after formation of the MLP as it did before. The Sponsor's interest in the MLP has merely replaced the assets conveyed to the MLP. Therefore, no revenue loss should result. It could possibly be asserted that the MLP equity substitutes for what would otherwise be new corporate equity and that the new corporate equity would generate additional revenues subject to the corporate sector's two-tier tax. The facts, though, simply do not support that assertion. No MLP equity has been found to be a substitute for corporate equity. Use of the MLP form, use of corporate debt or use of retained earnings are generally the only choices.

Thus, it would appear that only a Liquidation MLP or a Dropdown MLP, the interests of which are distributed to Sponsor shareholders, would result in MLP equity replacing corporate equity. Despite the conversion, it is still not clear that an erosion of the corporate tax base results. The distribution of the MLP interests actually accelerates tax revenues because of the two-tier tax imposed on such transactions. Only future appreciation escapes the corporate level tax and, then, only after a substantial "toll" charge. Because of the tax cost of this transaction, few will be done. The Dropdown and Acquisition MLPs otherwise result in an acceleration and enhancement of tax revenues. Interests in an MLP reflect asset values more clearly than corporate stock. This improved valuation results because the pass-through regime forces MLP managers to operate in a more efficient and economic manner. Thus, the taxation of appreciation in the underlying assets held by MLPs, which occurs as the MLP interests are traded in the public marketplace, is accelerated, accelerating tax revenues that would otherwise await the corporate sale of assets.

Future Corporations. The larger threat of disincorporation and erosion of the corporate tax base, if one exists at all, would arise if the MLP provided tax and operating benefits that far exceeded benefits provided by the corporate form. In such case, balance in the entity selection process would be lost and the corporate form would become obsolete, resulting in an unacceptable revenue loss to the fisc.¹⁴ Notably, this concern would only extend to enterprises accessing for the first time the public capital markets, and only those not already operated in corporate form.¹⁵

Adding to the earlier observation that the incentive to disincorporate under the new rate structure is largely overstated, the disincentives to operating a publicly owned business in partnership form are largely understated. The most significant reason not to utilize the partnership form, particularly when interests are publicly traded, is that partnerships are at a substantial competitive disadvantage to corporations in accessing equity capital provided by institutions (both taxable and tax-exempt) and foreign investors. The principal roadblock to tax-exempt equity capital is attributable to the unrelated business taxable income ("UBTI") rules.¹⁶ Moreover, trusts, savings banks, insurance companies and other state regulated institutions (both taxable and tax-exempt) are prohibited from investing in partnerships by certain state law prohibitions.

An additional disincentive to institutional investors is that MLP interests are high yield-oriented instruments. Institutions have historically been attracted primarily

¹³ MLPs use substantially less debt than corporations. While it is commonplace for a corporation to have a 4 to 1 debt-equity ratio, an MLP debt-equity ratio approaching 1 to 1 is rare. For example a corporate vehicle used in a leveraged buyout often is capitalized with 90% to 95% debt while those few Acquisition MLPs formed to date have 50% or less debt.

¹⁴ One who is strongly committed to an integrated system would argue that such revenues would be replaced by revenues resulting from the more economically efficient application of capital which would occur in an integrated system.

¹⁵ As discussed, the up-front tax costs of converting an existing corporation to an MLP appear to effectively prohibit this form of disincorporation.

¹⁶ The UBTI rules require that an otherwise tax-exempt entity be taxed on its allocable share of most partnership taxable income, just as if such entity was directly engaged in the trade or business conducted by the partnership. Even if the partnership fails to generate net taxable income, the tax-exempt institution may find unappealing the UBTI rules requiring it to file federal income tax returns because its allocable share of gross UBTI exceeds \$1,000. Either a tax payment or a tax filing obligation appears to be sufficient to preclude tax-exempt participation in MLP investments.

to growth businesses. Growth is viewed as much less obtainable by a yield-oriented entity which, as a result of market demands, must distribute significant amounts of cash. In the case of many MLPs, the demand of the marketplace for cash is such that the MLP is viewed as a self-liquidating enterprise. Institutions have also shied away from MLPs as a result of the administrative burden (and related reduction in economic returns) associated with multiple state filings of income tax returns, a burden imposed upon taxable and tax-exempt institutions alike. Lastly, institutions are reluctant to invest in MLPs because of the relative illiquidity of the MLP marketplace. MLP interests are traded with much lesser frequency than corporate stocks. The lower volume of trading makes it difficult for large block holders (as institutions would be) to move in and out of the market without exposure to large, disadvantageous price fluctuations.¹⁷

Similarly, foreign investment capital is not readily accessible by the MLP. As a partner in a partnership conducting a U.S. trade or business, foreign investors are deemed engaged in such trade or business and, as a result, are subject to filing a U.S. tax return and paying a tax on their distributive share of MLP income. The increased administrative cost alone may reduce the yield to an unacceptably low level. In addition, as an added measure to ensure compliance, MLP distributions to these same partners will generally be subject to withholding which also results in a reduction of after-tax yields since taxes are being prepaid by as much as one year. As a result, foreign investors cannot be counted on by MLPs as a source of capital.

An MLP, unlike the corporate vehicle, simply does not have access to the institutional equity market -- the single largest source of equity capital. For similar reasons, it has little, if any, access to the foreign equity capital market. For these reasons alone, large or successive equity offerings can rarely be accomplished by MLPs in the retail market they depend upon, due to the limited nature of that market.¹⁸ Limited access to the institutional and foreign capital markets alone has proven to be, and will continue to be, more than adequate disincentive to most to use the MLP.

Most of those few business managers who have found this lack of access to institutional and foreign capital tolerable have been dissuaded from using the MLP form because of operational restraints imposed by the marketplace. These restraints are not generally imposed on the corporate form. MLPs are single purpose, narrow enterprises subject to very restrictive reinvestment limitations. They must provide their investors with substantial current yields. Such current yields simply cannot be maintained unless all reinvested cash flow, within the narrow limits allowed, is reinvested with a degree of efficiency ensuring that the yield will not be diluted. Corporate managers, on the other hand, are accustomed to investment decision making on a noncurrent yield basis.¹⁹ Accordingly, most corporate managers are reluctant to use the MLP form. Doing so would (i) force them to forego their unlimited power to reinvest on behalf of shareholders and (ii) subject them to the disciplines of the MLP marketplace.²⁰

Another constraint on the use of the partnership form is the administrative costs associated with that form of doing business. Those administrative costs are associated with reporting and filing requirements applicable to partnerships which do not arise in the corporate context.

Current Treasury regulations pose still another problem for MLPs. The limited liability test imposed under the classification regulations requires that a corporate general partner maintain substantial assets in addition to its interest in the partnership. As a result of this requirement, Sponsors are forced to expose to the MLP's creditors assets that would otherwise likely be shielded from such exposure. Although every counsel has his own view of substantiality, Sponsors in the MLP arena will be forced to expose additional assets with a minimum value of \$7 million to \$10 million dollars. Although often ignored or treated with disdain by advocates of corporate

¹⁷ The institutional distaste for MLP interests is best illustrated by the experience of Community Psychiatric Centers, Inc., a corporation whose announced plans to liquidate into an MLP in December, 1986 were abandoned because of the lack of institutional shareholder support. Similarly, experience has shown that institutions typically sell MLP interests received by dividend immediately.

¹⁸ Of 25 MLP offerings completed and analyzed, 11 were reduced in size by an aggregate \$430.2 million because of the inability of the market to absorb the offered investment. Seven MLP offerings were increased in size but the aggregate increase was only \$196.5 million.

¹⁹ Instead, performance of corporate managers is most often measured by reference to such standards as earnings per share, a concept most believe is not a true indication of economic income.

²⁰ The best evidence of this reluctance is the absence of support from the corporate sector for prior attempts to integrate (in whole or in part) the corporate income tax system.

classification, this regulatory requirement has created some very real problems in structuring many MLPs.²¹

Other legal and practical differences between partnerships and corporations also discourage the use of the partnership form. For example, the uncertainties regarding the applicability of partnership law may prevent the use of the partnership form. Although state law applicable to partnerships is developing, the area is much less certain in its application than corporate state law. Similarly, the applicability of foreign laws to partnerships is a relatively new area, one which is unlikely to be tested first by major business or industrial enterprises. Finally, as was mentioned earlier, MLPs exist in the environment of a yield market. So much so that many MLPs have distribution support mechanisms which may require a subordination to the public of the Sponsor's cash flow or, in some cases, an injection of additional cash by the Sponsor. Such support mechanisms are designed to assure that the public investor will receive the expected cash yield in order to support market values. Where business does not have adequate, predictable cash flow (or a Sponsor willing to "guarantee" the existence of cash flow) to meet the cash yield demands of the marketplace, the partnership form is simply not a viable form for the business enterprise.

For these many reasons, it seems clear that a tradeoff of operating advantages and disadvantages of the corporate and partnership forms exists in the public equity market today. This tradeoff provides a fair balance in the entity selection process in such public market. Support for this proposition is evidenced by the fact that, to date, only 89 MLPs have been formed, excluding MLPs formed for the consolidation of existing partnerships. In dollar numbers, since 1982, approximately \$6 billion of equity has been raised, in the aggregate, by MLP offerings (approximately 75 separate issues). During the same five-year period, approximately \$193 billion of public corporate equity has been raised through common and preferred stock offerings (over 4,000 separate issues of common stock alone). Of the MLP transactions, only 20 were Liquidation MLPs (all completed prior to the effective date of *General Utilities* repeal) and, of the remaining 69, only 2 were existing enterprises not already operated in corporate form and accessing the public equity capital market for the first time. Furthermore, notwithstanding the supposed incentives to disincorporate provided by the 1986 Act, an average of only 4 MLPs have been formed each month since enactment while an average of 3 MLPs were formed in the 18 months preceding the effective date of enactment. These statistics seem to conclusively demonstrate that those government officials, practitioners, and members of the media screaming disincorporation are merely "crying wolf." Any threat of disincorporation attributable to MLPs pales by comparison to the erosion of the corporate tax base attributable to the spiraling increase in the use of corporate debt.²²

Revenue Impact

Under the present system in which MLPs are taxed as partnerships, a loss of revenue can only result if MLP equity capital (subject to a single tax regime) is replacing corporate equity capital (subject to a double tax regime). This simply is not the case. Historically, corporations have relied on debt and retained earnings as their least expensive sources of capital. Recent experience reflects an alarming dependence of the corporate sector on debt, with retained earnings serving as a source of repayment in the event such debt is not refinanced or "churned" (which is more often the case). Corporate stock issues represent a corporation's most expensive form of finance, due to the nondeductibility of dividends, and is rarely utilized. This has been the case either because (i) the corporation would not have been willing to suffer the dilution associated with a sale of substantially undervalued stock, (ii) use of stock would have been the most costly source of capital or (iii) the corporation would have been unable to sell stock under then market conditions. It is not surprising that during the same period that corporations raised \$192 billion in equity, they also raised over \$651 billion in long term debt alone.

To the extent that corporate debt is replaced by MLP equity, no tax revenue is lost since both debt and partnership equity are subject to single tier tax regimes. Actually, a conversion of corporate debt to partnership equity will result in an increase in tax revenues to the extent the corporate debt was held by either a tax-exempt institution or a low taxable entity.²³ To the extent that corporate retained earnings are

²¹ I have addressed the legal distinctions between the corporate and partnership forms at length in testimony previously submitted to this Subcommittee in its hearings on pass-through entities held June 9, 1986.

²² Since 1980, corporate debt has risen from 95% of corporate equity to 117% of corporate equity according to the Federal Reserve Board.

²³ Notably, the debt market is dominated by pension funds, life insurance companies, casualty insurance companies, commercial banks and thrifts, all organizations that pay little or no taxes.

replaced by MLP equity as a source of capital, there should result an increase in tax revenues since such earnings would then be available for distribution to shareholders. Accelerating the distribution of these earnings would in turn accelerate the imposition of the second tier of the double tax. In other words, a corporation's use of MLP equity as a source of capital forces it to forego the tax deferral advantages otherwise gained from a reinvestment of earnings. Thus, a common sense analysis seems to inevitably reach the conclusion that MLPs are, at worst, *revenue neutral*, but more likely *revenue positive* in the near term.

A logical extension of this analysis leads to the conclusion that classification of MLPs as corporations could result in a *revenue loss* during the five year period often used in a budget analysis.²⁴ To the extent MLP equity is eliminated as a source of capital, corporate managers would simply turn back to debt or retained earnings as a primary replacement for such lost source of capital. Based on historic trends, only a very small portion of MLP equity would be replaced with new corporate issues. In fact, to my knowledge no one MLP has sold partnership equity which would have been corporate equity had MLPs not been available. In short, if an MLP is treated like a corporation it will act like a corporation. It will increase its debt load, reduce dividends as a result of increased reinvestment of earnings and look for other ways to shelter its income. Tax revenues should either be unaffected or losses will be incurred during the short term due either to an increase in institutional held debt or to the postponement of corporate dividends from the increased retention of earnings. In the latter case, such tax revenues will ultimately be collected on the eventual distribution of the retained earnings. Unfortunately, the "turn around" will be far into the future since, absent a dramatic change in the structure of corporate taxation (such as an integrated system), there exists on the horizon no incentive to change old habits of postponing the dividend tax and sheltering the corporate tax through reinvestment.

LEVEL PLAYING FIELD

Probably the most used (if not overused) argument for taxing MLPs as corporations is the corporate resemblance argument, i.e. an MLP so closely resembles large, publicly traded corporations that it must be taxed as a corporation. In other words, to administer the taxing system fairly and to maintain the integrity and neutrality of the corporate tax, similarly situated taxpayers should be taxed in the same manner. Only substantive differences in the relative positions of taxpayers should justify application of different taxing regimes.

The focus of these neutrality principles should not be directed toward the relative positions of the corporate and MLP investors. Because capital markets are competing for the same dollar, it must be assumed that after-tax returns to these investors have been equalized by the marketplace in pricing the securities. Such pricing process would smooth the impact of the rate differentials. The level playing field or neutrality argument should instead be directed to any unfairness that exists from the entity perspective. This element of unfairness, if it exists, results from the corporate tax, in that a corporation's investment financed with new share equity must earn a higher pre-tax return than a partnership's investment in order to pay the provider of such equity his required after-tax return. The concern is simply that the higher cost of capital resulting from the corporate tax unfairly discriminates against a public corporation in competing with an MLP for the same capital dollars. Certain advocates of neutrality would assert that the corporate tax should be levied against MLPs to protect corporations from this perceived competitive disadvantage.

Fundamental Weakness. From an economic policy perspective, the level playing field argument applied in this manner appears substantially flawed. Such argument promotes a segmentation of the U.S. capital markets and attempts to establish a parity between certain of these segments. The problem with this approach is its inconsistency in only requiring parity within the "new equity" segment of the corporate capital market, a segment that only accounts for an approximated 3% share of the U.S. capital markets. Such parity clearly does not presently exist between the debt and equity segments of the corporate capital market. In fact, a level playing field does not presently exist between public corporations themselves and their access to the various segments of the corporate capital markets. For example, a General Motors certainly has far greater access to debt (the cheapest source of capital) than many, if not most, other publicly held corporations. It seems somewhat unreasonable to require that a level playing field be established between General Motors and ABC Limited

²⁴ The conclusion that a revenue loss could result from entity reclassification ignores any revenue benefit derived from the automatic conversion of MLP income to portfolio income that results from the corporate classification of MLPs. For this purpose, it is assumed that any such revenue benefit should be severed and viewed separately from any revenue estimate of an entity reclassification. See text accompanying footnotes 25-27.

Partnership, when one doesn't even exist between General Motors and other public corporations.

The U.S. capital markets are highly interrelated and very competitive. New investment projects in any industry must compete with all other investments for the same dollars. It appears questionable whether it constitutes good economic or tax policy to attempt to segment these capital markets and arbitrarily establish a level playing field between only certain of such segments. In fact, with over 75% of U.S. investment bearing either no tax or a single tax and only 3% of such investment bearing a full two-tier tax, principles of neutrality would seem better served if the single tax regime were imposed on all capital investments.

Different Playing Fields. If principles of neutrality must be applied in reviewing MLP classification, perhaps the conclusion should be that the MLP and the public corporations are both playing on level fields, they just happen to play on different fields. In other words, to subject the MLP to principles of neutrality it must be assumed that the MLP and the publicly traded corporation are similarly situated. Although from a most superficial perspective the two entities may look very similar, on closer examination it becomes apparent that the MLP and the publicly held corporation are very different organizational forms.

As discussed, a number of substantive legal and operational differences ensure against a tilting of the balance in the entity selection process. These same distinctions clearly establish the fact that the two entities play on separate fields. Any benefit the MLP manager derives from accessing a cheaper source of equity capital is more than offset by his loss of access to institutional and foreign capital and his loss of unlimited discretion to reinvest after-tax earnings (an even cheaper source of capital). Simply put, the corporate manager is not placed at any competitive disadvantage to the MLP manager in accessing the public capital markets, such that the imposition of the corporate tax cannot be justified.

Tradeability. Assuming principles of neutrality, when properly applied, constitute good policy, it must be questioned whether such policy is well served by effectively imposing a tariff on the extrinsic feature of tradeability. There appears to be little intellectual justification for distinguishing MLPs from other large, but nontraded, public and private partnerships and singling them out for double taxation. Doing so effectively imposes an enormous penalty on the investor liquidity provided to the individual owners of the business. This result appears inconsistent with the fact that the perceived advantage (lower cost equity capital) that necessitates the imposition of the corporate tax is supposed to be possessed by the MLP, not the investors who benefit most from liquidity.

The corporate classification of existing MLPs would ultimately lead to either a liquidation of the MLP or its eventual delisting. Future partnership offerings would be done as public offerings of unlisted interests. The small investor who has gained access to a form of direct participation in a pure economic investment in various operating businesses through the MLP would lose such access. Wealthy individuals who do not have the same need for liquidity as the small investor would retain access to such direct investment, gaining the benefits of the pass-through tax regime. Large publicly registered but unlisted partnerships with thousands of disinterested partners, with a far greater share of the capital markets and with many of the same business activities presently found in MLPs would continue to exist. These partnerships would not be hindered by the level playing field argument. It is difficult to see how any policy goal of fairness, integrity or neutrality has been well served in light of this seemingly egregious result.

ADMINISTRATIVE CONCERNS

Only if the administrative problems arising under the partnership model are so severe when applied to MLPs that tax liabilities of the interest holders cannot be determined or collected, should such problems be taken into account in determining the classification of the MLP. This does not appear to be the case, at least from a compliance standpoint. Prior to the 1986 Act, the most serious compliance issue faced by MLPs was inadequate reporting procedures for street name owners of MLP interests. With the nominee reporting rules and attendant penalties, these compliance problems with street name owners should be substantially mitigated (especially once the clearing house system has had time to develop). The establishment of this communication link between the MLP and its street name owners should also provide solutions to many less severe problems involving identification of certain classes of partners.

Collection of partnership deficiencies is another administrative concern that needs addressing. Certain audit adjustments may not warrant the effort of collecting a

deficiency from thousands of partners. A partnership level system of collection may be warranted. There are other technical problems that need addressing, but nothing that even approaches a magnitude that would justify corporate classification.

REVENUE: PASSIVE INCOME

The fisc would appear to be much better served by this Subcommittee considering legislation characterizing income from most, if not all, MLPs as other than passive income.²⁵ Such treatment, as a matter of fundamental tax policy, is predicated on the same theory underlying the treatment of portfolio income: a taxpayer positioned to receive projected and periodic income from investments should not be given opportunities to shelter that income when the same opportunities are not available to the wage earner. Failure to reclassify MLP income not only poses a revenue drain but also results in disparate treatment of fundamentally similarly situated taxpayers.²⁶

Furthermore, there seems to be a sound policy basis upon which to distinguish MLPs from other partnerships in such treatment. Not only is an MLP investment similar to a portfolio investment in terms of the degree of risk and predictability of yield, but Dropdown MLPs could potentially be used by corporations as a means of converting into passive income earnings that would otherwise be distributed as portfolio income.²⁷

Classification of MLPs as corporations would automatically achieve the classification of income as portfolio income for purposes of the passive loss rules. The issue of an entity's income classification, however, should be addressed separately from the classification of the entity itself. The former issue can be dealt with without impacting the latter. Thus, any assessment of the potential revenue attributable to the entity classification issue must be reviewed without regard to the increased revenue resulting solely from the income classification issue. It would seem likely that the classification of MLP income as other than passive would have a greater short term revenue impact than would the classification of MLPs as corporations (even with its attendant conversion of passive to portfolio income).

CONCLUSION

Although the 1986 Act substantially increases the tax cost of operating in corporate form, it does not appear that these changes alone will prompt a realignment of the public company arena from the corporate form to the partnership form. The substantive disadvantages of a public company operating in partnership form have more than offset its tax advantages and provide a balance in the entity selection process. This balance should not be changed by the 1986 Act. The MLP form should continue to lend itself only to certain select businesses which have substantial net cash flows, minimal reinvestment needs and limited capital requirements (that do not exceed retail market capacity).

The administrative problems relating to MLPs would appear manageable, especially with the advent of the nominee reporting rules. There is little question that certain legislative and regulatory changes are appropriate to accommodate many of these concerns.

MLP equity has been used in the corporate sector as a replacement or substitute for debt capital (not new share equity). The use of MLP equity in such manner should be revenue neutral, if not revenue positive. Classification of MLPs as corporations would appear to result in a short term revenue loss from the corporate sector, if the revenue benefit ensuing from the automatic conversion of MLP income to portfolio income is disregarded. This Subcommittee should consider, as an alternative means of raising revenue, classifying MLP income as other than passive income for purposes of the passive loss rules. Such measure, if limited to MLPs, would not only be justified from a policy perspective, but would likely raise more revenue in the short term than corporate classification of MLPs.

²⁵ Many are of the view that Treasury has the authority, under the existing statute, to classify MLP income as other than passive income in its regulations.

²⁶ Although the corporate entity and the MLP entity are not at all similarly situated, the interest holder of an MLP is similarly situated with other portfolio investors.

²⁷ This "heads Treasury wins - tails taxpayer loses" approach should not trouble the MLP investment community. Pre-tax yields and business fundamentals seem to drive the investment decision in the case of MLPs. To the marketers of MLPs, the optimum tax result has always been substantially, if not fully, sheltered cash flow: a nontaxable, up front return of the investor's capital.

STATEMENT OF R. DONALD TURLINGTON, ESQ., BROWN & WOOD

Mr. TURLINGTON. Mr. Chairman, my name is Don Turlington. I am chairman of the partnership committee of the New York State Bar Association, the bar association of which Mr. Schapiro, who spoke earlier, is the chairman. I also am a practicing attorney in New York, and a professor of law at the New York University School of Law, where I teach partnership taxation.

I want to make clear from the outset that I am here today on my own behalf, and not on behalf of any client or any other group.

In starting, let me observe that the picture of master limited partnerships that Mr. Mentz attempted to paint here today is a picture with which I am unfamiliar. Having practiced in New York, the community where Mr. Mentz use to practice, I want to point out that Wall Street has changed dramatically since Mr. Mentz left—and I think for the better. It appears that Mr. Mentz is not aware of what is going on in the MLP area. That was made very clear by some of the statements he made this morning.

For him to argue that MLP's are a hemorrhage on the corporate tax system, that they are a giant tumor that will be the death knell of the corporate income tax, is utter nonsense—particularly when you view MLP's in comparison to the tax revenue hemorrhage that is going on all around us every day, the hemorrhage of corporate debt. That is where the revenue loss is, in fact, coming from.

One need look no further than the Federal Reserve Board figures for 1986 to see that fact. In 1986 the net equity investment in corporations declined \$80 billion. The amount of corporate debt, on the other hand, went up \$136 billion. For Mr. Mentz to say that MLP's, which raised less than \$3 billion of equity in all of 1986 are the gigantic threat to the corporate tax system, while ignoring these numbers, is, I believe, foolish, to say the least. I think perhaps what Mr. Mentz should do is get on the Federal Reserve Board mailing list so he will be more informed as to what these corporate debt figures are.

Just last week, Mr. Sprinkle, the Chairman of the President's Council of Economic Advisers, testified before the Senate Banking Committee that our current tax system—the tax system that Mr. Mentz apologizes for but can seem to do nothing about—is, in fact, the very system that is promoting leveraged buy-outs, leveraged recapitalizations, and hostile takeovers of corporations. The reason for that is nothing more than the fact that it is so much cheaper to capitalize or capitalize a corporation with debt and replace its equity because you are arbitraging income taxes the corporation will no longer pay. It is that flaw in our tax system, and not MLP's, that Mr. Mentz should be focusing his attention on.

Contrary to what Mr. Mentz tried to lead you to believe—it is that niche that MLP's have filled—replacing or avoiding corporate indebtedness, not corporate equity.

Corporate executives realize that MLP equity has non-tax advantages that are substantial and significant when compared to corporate debt, not the least of which is that you have to pay corporate debt back. With corporate debt you also have to pay periodic interest. With MLP equity there is no maturity. You never have to pay

it back. All you do is hope to pay a yield to the investor who provided that equity. And, as Mr. Hortenstine pointed out, unlike someone who lends money to a corporation, the person who invests in an MLP can get angry if the distribution he expected from the MLP is not made. He can't sue. That, I believe, is a critical nontax advantage when a corporate executive goes into the market place to decide what is the safest and best way for him to raise capital to expand his corporation's business.

As chairman of the partnership committee on the New York Bar Association, Mr. Schapiro and I worked very hard—and in fact have had a series of meetings, both with the staff here and at Treasury—on ways to improve the structure for MLP's. It was by virtue of Mr. Schapiro's efforts, primarily, that the New York State Bar Association, earlier this month, reversed its position from 3 years ago to outlaw MLP's. In fact, the bar association rejected the proposal by Mr. Cohen to outlaw MLP's. Instead it said that MLPs have virtues to them—primarily in the area that I have mentioned, by replacing corporate debt—and that the MLP system should be improved, not outlawed.

There are ways that we can do just that and we have suggested several to the staff here and to Treasury. We can structure an entity, and a security that does, in fact, provide a benefit to the system from a tax policy perspective. You did just that last year when you enacted the REMIC legislation, something that you recognized was beneficial to the economy. I believe replacing corporate debt with MLP equity that doesn't go into default in the next recession, is also beneficial to the economy. The New York State Bar Association stands ready to assist this committee in coming up with that structure.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Turlington follows:]

June 30, 1987

United States House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures
Washington, D.C. 20515

Statement of R. Donald Turlington
on Issues Relating to The Tax Treatment
of Master Limited Partnerships
for Federal Income Tax Purposes

Gentlemen:

I am a practicing attorney in New York City with the law firm of Brown & Wood. I am Chairman of the Partnership Committee and a member of the Executive Committee of the Tax Section of the New York State Bar Association. I also serve on the faculty of the New York University School of Law in the graduate tax program where I teach the course on taxation of partners and partnerships. I am also Editor-in-Chief of the Journal of Partnership Taxation, a quarterly publication for partnership tax practitioners published by Warren, Gorham & Lamont.

This statement is submitted to the House of Representatives Subcommittee on Select Revenue Measures of the Committee on Ways and Means in connection with its hearings on issues relating to the federal income tax treatment of publicly traded partnerships (master limited partnerships or "MLPs").

The purpose of this Statement is to address some of what I consider to be major issues that may arise in the context of any evaluation of the federal tax treatment of MLPs. However, I have made no attempt to resolve all of the issues raised by the current tax treatment of MLPs. Rather, where it may be appropriate, I have given my views and suggested certain possible solutions for consideration by the Subcommittee and the Staff.

INTRODUCTION

I believe that the current system of corporate taxation is seriously flawed and that an integrated approach to business taxation similar to the partnership model is superior from the standpoint of sound tax policy. Pending issuance of Treasury's Subchapter C report and implementation of a viable system of corporate tax integration, classification of MLPs as partnerships should be maintained for several policy reasons.

First, substantially all capital raised from the public through MLPs is used by corporations sponsoring the MLPs to pay off, or as a substitute for, corporate indebtedness. Thus, MLPs enable corporations to strengthen their financial condition by issuing securities which impose no risk of default on the MLP or its corporate sponsor. I believe this policy benefit outweighs the technical arguments made by those who advocate taxing MLPs as corporations.

The second policy reason for continuing to treat MLPs as partnerships is that MLPs enable corporations to highlight the true value of selected assets, thereby enhancing shareholder values and fending off hostile takeovers.

The third policy reason for continuing classification of MLPs as partnerships lies in the fact that by offering liquidity, MLPs give small investors the opportunity to invest on an equal after-tax basis with wealthy investors. Sound tax policy is served by maintaining a level playing field for all investors - whether rich or poor.

Since MLPs afford corporations a "single tax" alternative to raise capital in lieu of the "double tax" alternative of issuing new stock, their impact on corporate tax collections is a relevant issue for this Committee to consider in any evaluation of the tax status of MLPs. In that regard, I seriously question whether MLPs result in substantial revenue loss from the corporate sector. One level of tax is imposed on income allocated to all partners in an MLP, whether those partners are individuals, corporations, foreigners or otherwise exempt institutions. It is naive to believe that income earned by most large corporations today is taxed more heavily just because corporations purportedly are subject to a double tax regime. Rather, a substantial amount of corporate income is subject at most to only a single tax since it is paid out as interest on corporate debt. Income paid out as interest on corporate debt is completely deductible by the corporation. To the extent

that interest is paid to tax exempt institutions and pension funds, it is not taxed at all. For that reason a single tax on 100 percent of the operating income earned by an MLP may well be higher than the taxes imposed on a typical corporation, its shareholders and its creditors, conducting exactly the same business.

With respect to tax compliance difficulties associated with MLPs, much progress has been made, primarily through the partnership level audit procedure and the institution of nominee reporting. To reduce tax collection difficulties, I recommend that MLPs be subject to a form of partnership level deficiency assessment and collection procedure.

As a final point, I would urge that Treasury or Congress confirm that income from an MLP is not passive income for purposes of Section 469,¹ as enacted by the Tax Reform Act of 1986 (the "1986 Act").

POLICY CONSIDERATIONS

One of the major issues concerning the tax treatment of MLPs is whether pass-through taxation is good or bad tax policy. The alternative is to impose a corporate tax on all enterprises that are denied access to a viable scheme of pass-through taxation.

The evils of the current corporate tax are well understood and acknowledged,² even by those who advocate taxing MLPs as corporations. In his testimony before the Rangel Committee in 1986, the Assistant Secretary of the Treasury for Tax Policy acknowledged that:

[m]ost economists agree that income from business activities carried on through separate legal entities should not be taxed more onerously than income from activities not conducted in entity form. This view is grounded in the proposition that a market economy operates most efficiently if all business activities are subject to the same rate of tax.

* * *

As a matter of ideal tax policy, income from different business activities should be taxed at equivalent rates, irrespective of the form of business entity. We recognize that a failure to integrate the corporate and individual income tax systems will perpetuate differences in effective tax rates.

The tax systems of most major industrial nations provide some degree of integration of the corporate and individual income tax. For example, Canada relieves 40 percent, France 50 percent, and the United Kingdom 80 percent of the double tax on distributed income by allowing shareholders a tax credit for a portion of the tax paid by the corporation. Japan relieves 38 percent and West Germany 100 percent of the double tax burden on corporate income by applying a reduced rate of corporate tax to distributed income and allowing shareholders a tax credit for part or all of the tax paid by the corporation on the distributed income.

There are many benefits to be gained by adopting a tax system that imposes the same rate of tax on all business income, not the least of which is to eliminate the existing tax incentives to capitalize corporate activities with debt rather than equity. Also, by having a single tax system, individual taxpayer-voters will be more aware of their actual tax burden so they will be

1 Unless otherwise indicated, all "Sections" or "§" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." or "regulations" references are to the regulations thereunder.

2 See Charles E. McLure, Jr., Must Corporate Income Be Taxed Twice?, Brookings Institution (1979); George F. Brenk and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream?, Brookings Institution (1975) pp. 90-104.

3 Statement of J. Roger Mentz, Assistant Secretary (Tax Policy) Department of the Treasury before the Subcommittee on Select Revenue Measures (the "Rangel Committee"), Committee on Ways and Means, U.S. House of Representatives (June 9, 1986) (hereinafter referred to as the "Mentz Statement").

better informed as to their true share of the price we pay for civilized society. Whether corporate income taxes are deemed imposed on the corporation's shareholders, its employees, or its customers, they are an economic cost ultimately imposed on individuals. Yet each of these constituencies likely perceives that the tax burden is imposed elsewhere. If the needs of government require additional tax revenue, individual taxpayers should be aware of the corresponding tax costs. Only in that way can they decide, through the electoral process, whether the attendant benefits of government spending are worth the burden. Unfortunately, failure to integrate the corporate tax system, either using a dividend relief approach or the partnership model, seems based upon one overriding political factor - the government needs the revenue raised by the current two-tier tax on corporate income.⁴

Potential loss of tax revenue is indeed a problem of national concern. Although I am not an economist, I question whether the decision to tax all publicly traded partnerships as corporations will increase revenue. More to the point, I am convinced that such a decision will further accelerate the current trend of corporate management to issue debt as the primary means of raising capital, a trend which allows substantial amounts of corporate income to escape taxation at any level, and which undermines the economic stability of the United States.

Consider the alternatives currently available to corporate management seeking to raise capital to fund expansion or the acquisition of a new business: (1) to issue additional stock (the "stock alternative"); (2) to retain corporate income over a long period of time rather than distributing it to shareholders (the "income accumulation alternative") or (3) to issue debt (the "debt alternative").

The stock alternative, if chosen, is favorable, both with respect to tax revenue and economic stability. On the revenue side, it should maximize tax revenue over the long term since the income earned on the newly raised equity capital ultimately will be subject to two levels of tax. It would also contribute to the stability of the national economy because it would not increase indebtedness in the corporate sector and would not subject corporations to the risks of bankruptcy and their employees to the risks of unemployment. Yet prospective investors in corporate stock think in terms of their after-tax yield. In order for a corporation to issue stock providing an after-tax yield to investors comparable to that of debt, the corporation first has to pay the full corporate level tax on its earnings unreduced by distributions to its stockholders. Thus, a corporation cannot sell stock providing an after-tax yield comparable to that of debt unless the corporation earns substantial additional pretax income sufficient to pay the corporate level tax on that income.

The income accumulation alternative certainly does not maximize government revenue because corporate earnings not paid out to shareholders are not subjected to the shareholder level tax on dividend income. Although upon initial consideration the promotion of corporate savings does not seem an improper policy consideration, the lesson corporate executives have learned in recent years is that corporations which retain income in the form of liquid assets pending the acquisition of a new business (instead of spending that income immediately or paying dividends) are inviting targets for hostile takeovers. Thus, the income accumulation alternative is not often a wise business choice, and it is rarely made.

The debt alternative has the most negative impact of all on corporate tax revenue and it creates dangerous instability in the national economy. At the corporate level, the earnings generated by the newly raised capital are offset, for the most part, by interest deductions. At the creditor level, interest income is subject to taxation only if the creditor is not a tax-exempt institution, pension fund, or foreign investor. It goes without saying that a substantial amount of corporate debt is held by such investors. Thus, the optimum method of raising capital in the corporate sector is to raise it by issuing debt to tax-exempt entities. To that extent, corporate level income paid out as interest escapes all taxation.

⁴ Mentz Statement, supra note 4, at 25.

The fact of the matter is that corporations now rely most heavily upon debt capital as a substitute for equity capital because it is much more tax efficient and economical to do so. The failure to integrate the corporate tax system while at the same time permitting the unlimited deduction of interest on corporate indebtedness is the principal driving force behind the recent surge of leveraged buy-outs and corporate debt recapitalizations. That fact is made clear since a corporation heavily capitalized with debt will be worth much more on an after-tax basis than the identical corporation capitalized with equity in the traditional manner. Unfortunately, capital raised by issuing corporate debt subjects the corporation to the risk of bankruptcy if its income is insufficient to make the required payments of interest and principal. The debt alternative makes short-term economic sense for the corporate financial officer, but it creates long-term economic instability for the United States.

Master limited partnerships offer a unique equity alternative to corporate financial officers who otherwise would capitalize their businesses with substantial debt. From a tax revenue standpoint, this alternative should not be adverse to the fisc compared to the debt option. In fact, this alternative may raise more tax revenue. Unlike debt, partnership equity (even if held by tax-exempt institutions and foreigners)⁵ subjects the MLP's operating income to one full level of taxation.

The primary economic benefit achieved by permitting corporations to raise capital through an MLP rather than a debt offering is that MLP capital is in the form of equity. I believe that the benefit of long-term economic stability, both to the business sector and the economy as a whole, justifies preserving the MLP option as a means of raising capital in lieu of raising capital by issuing debt.

The current corporate tax system readily lends itself to the reduction of the statutory tax burden on corporate equity. It is common knowledge that few corporations pay taxes at an effective rate approaching the maximum corporate rate. The current corporate tax system forces corporations to rely heavily on debt as a substitute for corporate equity because the cost of debt -- interest -- is fully deductible and reduces corporate level taxes. It seems clear that the current corporate tax system forces a business operated in corporate form to have a more highly leveraged capital structure than would the same business operated in MLP form. All of the income earned by an operating MLP allocable to its partners is taxable at least once, whether the partner is an individual, a

- 5 The Federal Reserve's domestic financial statistics reveal a frightening fact -- the net equity investment in corporations in 1986 went down by \$80.8 billion. At the same time corporate net borrowing skyrocketed by \$136.6 billion. Federal Reserve Bulletin at A42, Table 1.57 (May 1987).
- 6 The unrelated business taxable income ("UBTI") rules, contained in §§ 511 - 515, were enacted to eliminate any competitive advantage that a tax-exempt person engaged in a business might enjoy over a fully taxable person. Thus, the result of the UBTI rules is that an otherwise tax-exempt institution becomes taxable on its allocable share of partnership taxable income because, in general, a partner in a partnership is treated as being engaged in the activity (or trade or business) of the partnership. Additionally, even if the partnership does not generate UBTI, a tax-exempt institution is required to file federal income tax returns if its allocable share of gross UBTI exceeds \$1,000. Similar considerations apply to foreign investors who own interests in MLPs. As partners in a partnership conducting a U.S. trade or business, foreign investors are deemed to be engaged in a U.S. trade or business (§ 875). Foreign partners who invest in MLPs, therefore, are subject to U.S. taxation on their distributive share of the MLP's profits. (§§ 871(b) and 882(a)). They must file U.S. tax returns (§ 6012) and distributions to them are subject to withholding. (§ 1446). Equity-flavored debt structures avoid these problems. Interest received from investment in debt instruments is free from tax if it qualifies as "portfolio interest" under §§ 871(h) and 881(c); alternatively, interest often is subject to reduced taxation under an applicable tax treaty.
- 7 Indeed, the principal driving force behind leveraged buyouts and leveraged recapitalizations has been the resulting elimination of the corporate-level tax, which dramatically increases the value of the corporation.

corporation, a foreigner or a tax-exempt institution. In contrast, a substantial percentage of income earned by corporations today is not taxable at all since it is paid to tax exempt institutions and foreign investors as interest.

NONTAX BUSINESS REASONS WHY CORPORATIONS USE MLPs

Considered in the light of current business realities, the MLP alternative provides corporations with an economically efficient means of raising capital in the form of equity rather than debt. The MLP alternative to the corporation seeking capital is not chosen for tax avoidance reasons. It is chosen for sound nontax business reasons. If a partnership is treated like a corporation, it will act like a corporation. It will increase its debt load, reduce dividends and look for other ways to shelter taxable income.

MLPs formed to date have been used by corporations predominantly to repay or to avoid corporate debt. The following examples illustrate how typical MLPs are used by corporations to pay off or avoid indebtedness.

Example I - Use of an MLP to Pay Off Corporate Debt: Assume that Corporation X has an operating business with assets worth \$1,000 and long-term liabilities of \$400; thus, its net worth is \$600. Corporation X earns \$100 of operating income (not including interest on its debt) on its \$1,000 worth of assets, i.e., a 10% pretax return. It must pay interest at a rate of 10% on its \$400 indebtedness. Thus, on \$100 of operating income, \$40 must be used to pay interest on its debt, leaving the corporation with \$60 of net taxable income.

Corporation X contributes these assets, subject to the \$400 of liabilities, to an MLP in exchange for MLP units worth \$600 - the net value of the contributed assets. Thereafter, the MLP issues new MLP units to investors in exchange for \$400. Thus, 60% of the MLP interests are still held by Corporation X and 40% of the MLP interests are held by the public. The MLP uses the \$400 contributed by the public to pay off the \$400 debt shifted by Corporation X to the MLP. Thus, the business conducted by Corporation X is now conducted by the MLP which has \$1,000 worth of assets and no debt.

The \$400 worth of MLP units issued to the public are entitled to a 10% priority yield out of the MLP's income (i.e., the first \$40 of income), before a matching 10% yield (\$60) is paid to Corporation X.

Thus, if the business now conducted by the MLP continues to earn \$100, 40% or \$40 would be treated as a priority distribution of taxable income to the public investors as their yield on the \$400 of capital they contributed. The remaining \$60 would be allocated to Corporation X. If the business only earns \$40, all \$40 will be allocated to the public investors. Nothing will be allocated or distributed to Corporation X. If no income is earned, nothing will be allocated or distributed to the public unitholders or to Corporation X.

- 8 Of the MLPs formed to date which have raised cash, substantially all of the cash proceeds were used to retire corporate debt and nearly all funds raised which went to the corporate sponsor (in a secondary offering or in a sale of assets) were used to retire corporate debt. By dollar value, it is estimated that more than 95% of the cash proceeds raised by MLPs went to retire or avoid corporate debt. It is frightening to realize that the amount of corporate debt in the United States has increased dramatically in recent years by reference to every standard. For example, according to the Federal Reserve Board, as a ratio of debt to GNP, debt has increased from 1.35 to 1.7 since 1980. More to the point, the Federal Reserve Board also states that, during the same time period, corporate debt has grown from 95% to 117% of corporate net worth. It goes without saying that a significant cause of this increased reliance on corporate debt rather than equity is the fact that our current corporate tax system rewards the use of debt and penalizes the use of equity.

Example II - Use of an MLP as an Equity-Based Alternative to a Corporate Leveraged Buy-Out: Corporation Y, a public corporation, owns a business it has conducted for a number of years. That business earns \$100 of operating income before taxes. Corporation Y pays \$40 per year of tax and distributes the remaining \$60 as dividends to its shareholders.

Corporation Y's management wants it to raise cash to invest in another business. They will have Corporation Y do so by selling the assets used in its current business for the maximum price. Management has two alternatives to maximize the sales price for Corporation Y's existing business; a leveraged buy-out (an LBO) or an MLP.

a. The LBO Alternative:

If the LBO alternative is selected, a corporation (the LBO Corporation) would be formed by management. The LBO Corporation would borrow as much as 95 percent of the value of the business to be purchased. Management would contribute the remaining 5 percent as equity to the LBO Corporation in exchange for all of its stock. The LBO Corporation would use the borrowed cash, together with the cash contributed by management, to purchase the target business from Corporation Y.

By virtue of massive interest deductions paid on its indebtedness, the LBO Corporation likely will pay very little income tax for a number of years. To make matters worse from a tax revenue standpoint, a substantial amount of that interest likely will be paid to tax exempt lenders. Thus, a substantial amount of the \$100 of operating income earned by the business sold to the LBO Corporation may never be subject to any tax.

b. The MLP Alternative:

If the MLP alternative is selected rather than the LBO alternative, the MLP would be formed with Y Corporation as its general partner. It would raise substantially all of the purchase price of the business by issuing MLP units to investors contributing cash. Almost all of the investors will be individuals. Few if any will be tax exempt institutions or pension funds. The MLP will buy the target business from Corporation Y for cash. Corporation Y will use the cash to pay its taxes on the sale and to invest in another business. The MLP will earn \$100 per year, all of which will be completely taxable to its partners.

An MLP formed in this manner is referred to as an "equity buyout MLP". It is the only price-competitive alternative to a leveraged buyout for a corporation that is seeking to sell selected assets.

There are substantial nontax business reasons why corporations want to raise equity capital through an MLP in lieu of borrowing.

1. Unlike corporate debt which has fixed due dates for payments of interest, MLP distributions, though similar to interest, are legally contingent upon the general partner declaring the distribution. Unlike corporate debt which has a specified maturity and must be repaid, MLP equity has no maturity. As securities issued to raise capital, MLP units are the safest form of equity to issue from the standpoint of a business.

2. Even though most MLP equity is structured to resemble debt in an economic sense, MLP equity does not appear as debt on the balance sheet of the

⁹ Most MLPs use very little debt. While it is commonplace for corporations to have 4 to 1 or higher debt-equity ratios (and LBO's a debt equity ratio of 20 to 1 or higher), an MLP debt-equity ratio even approaching 1 to 1 is very rare.

corporate sponsor of the MLP. Use of an MLP, therefore, enhances a corporation's credit rating and economic stability.

3. Unlike the case with traditional bonds or institutional financing which often contain substantial restrictive covenants (for example, prohibition or restrictions on payment of dividends), MLP equity imposes no such restrictions on the corporate sponsor of the MLP. Thus, an MLP affords a corporation maximum flexibility in its business affairs.

4. A corporation that has assets with a low book value but high fair market value and cash flow may contribute those assets to an MLP and sell a minority interest in the MLP to the public. By establishing a public market value for the selected assets in this manner, the corporation is able to enhance the value of its common stock. In the last several years, several large corporations have done exactly that as a defense against hostile take-overs.

5. Corporations use MLPs to expand their capital market access to reach small investors by providing those investors with quasi-debt type securities having liquidity. Unlike corporate bonds and non-traded partnership equity where the price of the initial investment may range from \$5,000 to \$25,000 or more, the price per unit of most MLPs ranges from \$5 to \$30. Because of the relatively low unit price, MLPs attract investors of moderate means.

There is much to be said for a tax system that rewards financing business enterprises with equity rather than debt. In this regard, Congress should think long and hard as to whether the United States economy is well served by denying businesses the ability to raise capital by selling partnership equity when the most cost-effective alternative is to issue even more corporate debt. Corporations can go bankrupt if their income is insufficient to pay their debts as they come due. No corporation raising capital through an MLP will ever go bankrupt if the MLP is unable to make a contemplated cash distribution to its partners, whether because of a downturn in business, a recession, or otherwise. In direct contrast, limited partners in an MLP who do not receive expected distributions can get angry. But unlike creditors, they cannot sue.

ISSUES REGARDING ADMINISTRATIVE COMPLEXITY OF, AND COMPLIANCE CONCERNS ARISING FROM, MLPs.

In deciding whether MLPs should be taxed as partnerships or as corporations, an important consideration must be whether the pass-through method of taxation has a material effect on taxpayer compliance or the ability of the IRS to administer the tax laws. In its testimony before this committee last year the Treasury pointed out that utilization of the partnership model for complex entities, the interests in which are widely held and frequently transferred, creates difficulties both for the Internal Revenue Service and for the partnerships and partners themselves. I agree. But I do not agree that the nontax benefits MLPs offer to certain businesses and to the economy as a whole should be outlawed as a result. Rather, the current administrative and compliance difficulties should be corrected. In this regard, I will discuss below several aspects of the current tax law regarding MLP audit and tax collection procedures that I believe should be corrected.

1. MLP Audit Issues. Section 6221 requires that the tax treatment of any partnership item generally be determined at the partnership level. In addition, partners must treat partnership items in a manner which is consistent with the partnership return or must notify the IRS of any inconsistent treatment.

The partnership audit provisions of Sections 6223 to 6231 establish a system for the conduct of proceedings for the assessment and collection of tax deficiencies (or for the refund of tax overpayments) arising out of a partner's distributive share of partnership items. Such proceedings must generally be

10 Mentz Statement, supra note 4.

conducted at the partnership level rather than the partner level.¹¹ Final administrative or judicial determinations obtained under the partnership audit rules are binding on all partners. I believe these rules represent a significant improvement over the law in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982, under which settlement or judicial determinations of disputes with respect to partnership items were only binding on the individual partners to the settlement or action.

2. Expansion of Tax Matters Partner's Binding Settlement Authority under Section 6224. Under Section 6224, the tax matters partner (the TMP) may enter into a settlement agreement with the IRS that will be binding on most, if not practically all, of the partners in an MLP. Partners having one percent or more of the MLP's profits, however, and other partners who join together in a group having at least five percent of the MLP's profits, are not bound by a settlement agreed to by the IRS and the TMP. I find it difficult to believe that such a group of MLP unitholders would find it economical to litigate against the IRS in this situation yet current law affords them that privilege. If, as an equitable matter, substantial partners (or a group of partners collectively having a substantial interest) in any partnership should be given the right to reject an audit settlement, as Congress determined when enacting Section 6224, I believe that right should be denied partners in an MLP as a price they pay for the benefit of freely tradeable interests. Therefore, consideration should be given to expanding the settlement power of the TMP of an MLP to cover all partners. Given this authority, under the partnership audit provisions it cannot fairly be said that the audit of a partnership's activities and the resolution of disputes as to the treatment of partnership items would be significantly more difficult than the audit of a corporation.

3. Partnership Level Tax Deficiency Collection. While the auditing of the activities of an MLP should not be of major concern, the difficulties of collecting any deficiencies that arise as a result of an audit raise more serious issues. Although the treatment of partnership items is determined at the partnership level, the federal income tax relating to partnership items still must be assessed against, and collected from, each partner. When there are thousands of partners involved and deficiencies against individual partners are quite small, the IRS may not have much of an appetite for pursuing those partners. Indeed, there may be instances in which the administrative cost of pursuing individual partners are prohibitive when compared to the potential taxes recoverable.

There is little experience to date with the partnership audit rules. To my knowledge, only one MLP has even been audited. No deficiencies have been asserted to date against any partners in that MLP. To some extent, therefore, this problem is only a potential problem that may develop in the future as MLPs undergo routine audits. Nevertheless, I believe action should be taken by Congress that would alleviate any problems that do emerge. The MLP and the IRS have a mutual interest in avoiding the assessment and collection of deficiencies from individual partners. The IRS wants to avoid the administrative burden and the MLP wants to avoid the embarrassment, bad public relations, and costs associated with such proceedings. Even with partnership level audits and judicial determinations, tax deficiencies arising therefrom must be assessed against, and collected from, individual partners.

I am sympathetic to the IRS's concerns that collection of small deficiencies from large numbers of partners scattered over many IRS regions may cost more than the tax to be collected. Although the partnership audit rules do not expressly address the issue, with respect to existing law there appears to be no statutory impediment to the MLP itself paying an agreed upon amount of tax liability on behalf of its partners as a result of an audit. I suggest that Congress permit partnership level tax collection by the IRS as a requirement of continued partnership status for MLPs. Such a process would enable the IRS to collect the settlement amount directly from the MLP and avoid multiple collection actions against the unitholders. There are three patterns of audit adjustments that could arise. First, the audit may determine that all partners' income was understated. Second, it may determine that their income

¹¹ The Commissioner may, unless appropriately notified of the inconsistency, directly assess a deficiency with respect to any partner whose treatment of an item on his individual return is inconsistent with the treatment of that item in the partnership return.

may be overstated. Third, the income of some partners may be overstated and others understated.¹²

With respect to partners who would be entitled to refunds, they might be required to file individual claims reflecting their own tax status in the year of adjustment. With respect to partners owing deficiencies, the MLP would remit an amount on their behalf computed at the maximum tax rate. Any partner in a lower tax bracket could file a claim for refund to the extent his share of the tax paid by the partnership exceeded his actual deficiency.¹³

An additional benefit to this approach would be the inhibiting influence it would have on MLPs and their tax advisors with respect to tax return positions that may be challenged on audit. MLPs tend to file returns using conservative factual assumptions and legal interpretations. The specter of partnership level assessment in a later year should reinforce that tendency to the benefit of the fisc. I believe serious consideration should be given to developing and formally implementing such a settlement procedure.¹⁴

COMMENTS AND RECOMMENDATIONS REGARDING USE OF MLPs AS PASSIVE INCOME
PRODUCING VEHICLES TO ABSORB DEFERRED PASSIVE LOSSES

Section 469(h)(2) provides that income or loss from a trade or business conducted by a limited partnership allocated to a limited partner is considered to be passive income or loss. Congress considered this rule to be necessary, since most widely marketed (and hence the most costly to the fisc) tax shelters were in the form of limited partnerships.

To keep the 1986 Act revenue neutral, Congress classified tax shelter investments as passive activities, despite the fact that taxpayers had invested in them in reliance on prior law. It was this retroactive disallowance of tax benefits from prior investments that was expected to produce substantially all of the revenue from Section 469.

As the 1986 Act emerged from the Senate to be considered by the Conference Committee, it became apparent that promoters could easily take advantage of these provisions. One way would be to organize and market on a wide scale limited partnerships that were virtually certain to produce taxable income rather than losses. This technique would produce "investment yield" type income which could be sheltered with otherwise disallowed passive losses. Properly packaged, such investments could be expected to cause taxpayers to sell (or not invest in) stocks and bonds producing portfolio income and instead invest in passive income generating activities marketed in the same way.

To enforce the spirit of the passive loss rules (to prevent sheltering of positive income sources by losses from unrelated activities) and to protect the revenue estimates upon which the 1986 Act had been based, in Section 469(k)(3) Congress delegated to Treasury extremely broad authority to classify activities as passive.

On this point, I urge that Treasury exercise its authority under Section 469(k)(3) by providing explicitly that if partnership interests are publicly traded, income from such a partnership should be considered portfolio income. I believe such a rule would be within the Treasury's authority under Section 469(k)(3) and is appropriate. If there is any doubt as to the scope of Treasury's authority in this area, I urge that Congress itself clarify Section 469 to confirm that income from MLPs is not characterized as passive income.

12 This situation could arise, for example, if the allocation of income from the MLP among the partners was adjusted.

13 Given the relatively small investment by the typical limited partner in an MLP, it may be that most partners would find their refunds too small to justify filing a claim. In that case, the Treasury would receive a windfall.

14 Useful guidance may also be gleaned from the experience under § 6232(c) and the regulations thereunder which provide that a partnership "shall be treated as authorized to act for each partner with respect to the determination, assessment, or collection" of the windfall profit tax.

Mr. ANDREWS. Thank you very much.

I guess a problem that we're having is trying to determine—as we mentioned earlier today—is “how big is big?” One hundred and twenty-six since 1981, a fifth of those are rollups. We know there's no revenue loss there. How significant is this? Is it as significant as Mr. Mentz suggests—

Mr. TURLINGTON. Let me put MLPs in context for you. In one LBO last year there was twice as much money raised by issuing debt than all of the equity that was raised by MLP's. That puts it in context. Mr. Mentz gives all sorts of frightening statistics about how the percentage growth in MLPs is very high. Sure, if you start with zero and then you grow to one the percentage increase is quite substantial. But in terms of absolute dollar amounts, MLPs are decimal dust compared to the hemorrhage that's going on in corporate debt.

Mr. ANDREWS. That's a law school phrase, “decimal dust.”

Mr. HORTENSTINE. He's a law school professor.

Mr. TURLINGTON. If you do away with MLP's I'm going to have to go back to teaching school. [Laughter.]

Mr. HORTENSTINE. The only point I would add to that is that I think the only legitimate point made in Treasury's testimony—if it contains a legitimate point—is its expressed fear of future movement into the MLP sector of entities that would have been incorporated, in the absence of the MLP form. I personally don't think it will happen because, as I've said, I think there are significant restraints that keep certain growth-oriented or capital-intensive businesses from moving into partnerships. Since 1981 the tax rate structure has strongly favored the partnership form in the public markets and yet, I would estimate that there have been less than five—two to my knowledge—new businesses, that were not already in corporate form, moving into MLP form and accessing public capital. In fact, with the 1986 act changes, if you accept this theory of corporate displacement, you would have thought we would have had a tremendous number of liquidations, prior to the effective date of the *General Utilities* repeal, to effect this flight from the corporate double tax system into the MLP single tax system. Although there are different counts, I think all told there may have been a total of 15 public company liquidations into MLP's since 1981 with maybe 6 or 7 of those occurring at the end of 1986 once the 1986 legislation took its shape. I just don't see this theory of future corporate displacement proving out.

Mr. ANDREWS. Another point that was raised this morning is the suggestion that the motive behind forming an MLP is simply tax avoidance. I wonder if you all would comment on that. Is that the primary motive? Have MLPs been in your working experience used as a tax avoidance, as opposed to other motivating factors?

Mr. MCKEE. Again, the issue is: how do you raise additional capital in the most efficient fashion. It has been made clear everyone's first choice is debt. Debt is simply the lowest cost of capital that you can find. The next best seems to be an MLP since it too has a single tax feature to it, and therefore, although it's got an equity flavor and it's a little more expensive, it is preferable to stock, which is the most expensive because it must bear two levels of tax.

But the issuance of additional stock carries with it a number of other uncomfortable features from corporate management's perspective, for example, control dilution, that you really don't have when you do an MLP. When you do an MLP you are able to avoid a lot of the uncomfortable features that debt has and you don't pick up too many of the features that normally go with stock. You're able to maintain control. The only major thing you give up is you usually give up some upside equity participation to your investors.

It would be disingenuous to say that taxes don't play a role in people's decisions. Taxes always play a role because they influence the aftertax cost of capital to a manager. But there's a host of other decisions that go in that as well, and I think it's clearly a mix.

I think it's been stated over and over again, and I know it's like beating a dead horse, but most people view these things as alternatives to some type of debt instrument. Not very many people that I've dealt with get very excited when you say, "Well, why don't you issue a bunch of new corporate stock." Those guys don't tend to go, "Oh yeah. That's a great idea." They tend to go, "Well, you know, I think I'll—how about some junkier debt? If I have to put some more equity features into my debt, maybe I'll put a bigger kicker in it, but I don't want to issue corporate stock."

Mr. HORTENSTINE. Just a final note to add to that. I think the panelists here would tell you that they have sat in countless meetings with countless potential issuers, corporations that at least were considering the MLP form. Many of these corporations rejected the MLP form for various nontax reasons, not the least of which was its extremely limited access to institutional capital. I cannot impress upon you how significant a point that is, a point that was totally ignored, or just overlooked, in Treasury's oral testimony this morning.

Mr. KULLER. There's only one sentence in Mr. Mentz' statement, and in our experience it's the most significant result in raising new capital.

Mr. HORTENSTINE. The limited access to capital and the distribution pressures that an MLP imposes on a corporate manager must not be overlooked.

Mr. ANDREWS. The Secretary suggested this morning in his testimony, or proposed in his testimony, that we carve out a natural resources provision, that we use as a test whether it was a wasting asset not actively managed. That would be sort of a quasi-test that would be applied. Is that good tax policy?

Mr. McKEE. I start off with a fundamental notion that a two-level tax makes no sense at all. I have never read—and, again, I taught for 13 years—I never had anybody make any rational arguments about why you ought to have a two-level tax. And the system that we have today, it's been pointed out, is a two-level tax in form, but is generally a one-level tax in practice—or a no-level tax. But to try to debate the tax policy merits of what the scope of a silly tax ought to be is just awfully hard to do. The notion that the Treasury ought to try to expand a tax structure that they admit is intellectually unsound continues to mystify me. The problem that everybody has when they want to talk about this issue is:

everybody starts off and says, "two levels of tax are bad, but we have a two-level tax, and therefore." I always have a problem with the "and therefore." I want to make it as big as possible. I start off with "If it's a bad tax, maybe we've got to live with it, but let's not make it any worse than we've got to make it." When you get to that point I think you say, "The opportunity in the MLP arena to experiment in passthrough taxation for widely held businesses is sound," and the notion that you somehow want to say, "Well, passive assets are okay and active businesses are not okay," to me is a line that I just—I can't draw it for you, sir, because the fundamental notion of putting anything into a two-tier tax structure is just not a good idea.

Mr. KULLER. I have a more cynical response to that question. I think part of it is what Chairman Rangel said about a political response by the Treasury Department. I think that Treasury suggestion of a natural resource exception, as well as Treasury's desire to have very broad transition rules, or grandfather relief, is an attempt to divide and conquer, is an attempt to separate the people who are in favor of MLP's and against the Treasury's position. If they can at least buy off on the existing MLP's and buy off on the oil and gas MLP's, and the timber MLP's well maybe there won't be enough potential strength left to fight them.

Mr. HORTENSTINE. My comment would be that there is nothing unique about the oil and gas industry as far as the problem of overleveraging occurring in the corporate sector. MLP equity appears to be the only practical alternative to corporate debt, not that it will even make a slight dent in the debt problem. It is at least in the right direction, and every industry seems to have the overleveraging problem. So I see nothing in this context justifying a carve-out for any industry.

Mr. ANDREWS. You made a suggestion in your testimony, and that was that one suggestion might be to treat MLP income as portfolio income.

Mr. HORTENSTINE. Yes.

Mr. ANDREWS. I wonder if you would expand on that a little bit? I think that has merit, and I would really like to hear, Mr. McKee and Mr. Turlington, your—all of you to comment on it.

Mr. HORTENSTINE. I think there's a good policy justification for singling out MLP's in treating their income as portfolio or other than passive income. The justification is actually twofold: First, the MLP is one of the few—if not the only—passthrough vehicles through which the income of an operating business can arguably be converted from portfolio income into passive income to owners of that business. The business activities that would otherwise be conducted in a corporation and produce dividends taxable as portfolio income to shareholders can be moved into an MLP, and that income be distributed as passive income to the partners. Now, I'm not sure that's a pure conversion unless the same persons who are the shareholders that would have been receiving those dividends are also partners of that MLP. Even if they are not, however, a portion of the income from the specific business has arguably been shifted to the new MLP partners and sheltered from portfolio status. Thus, I see that policy argument. Second, MLP income has

the predictable and periodic characteristics that Congress intended to be characterized as portfolio income.

In all honesty, it is simply an easy solution for me to recommend, since MLP's are not in any way, and never have been, marketed on the basis of producing passive income. In fact, MLP's are marketed on the basis of providing as close to a fully sheltered cash yield—return of capital—as possible. So I would be surprised if you would run into any resistance from the MLP industry, and yet it's a ready source of revenue. In fact, we think it's the primary, if not the only, source of revenue in the entity classification issue.

Mr. ANDREWS. In fact, on table III of Mr. Mentz' testimony today, the revenue numbers are higher if it's treated that way.

Mr. HORTENSTINE. In the 3-year period?

Mr. ANDREWS. Yes.

Mr. HORTENSTINE. Well, if you consider the grandfather classification, the numbers are higher.

Mr. McKEE. I think the way those numbers, the way they developed them, will show that if you use the same grandfather rule there is a small incremental revenue raise from treating those things as corporations. Again, we dispute those revenue estimates. We found, from our analysis—or I should say Mr. Vasquez and Mr. Smith did, found from their analysis—that the active/passive issue actually raises more money than the incorporation, but that is certainly a disagreement between us and the Treasury Department.

Let me just say, to respond to your first question: any time the system has major tax consequences, such as whether you're in the active basket or passive basket, flow from the taxpayers choice of wrappers to put around his business vehicle—whether he calls it a subchapter C corporation which then generates dividends or interest, which is in one basket; or he calls it a limited partnership which now generates passive income, which now gets into the other basket—the system, I don't think, is well served.

I would suggest, supporting what Dale said, that we would be much better off by saying that if a business activity is going to generate active income, it ought to be active income regardless of whether you put it in an MLP or whether you put it in a subchapter C corporation. And, conversely, I would suggest that regardless of the form you put it in—if it's rental income, which the statute says is supposed to be in the passive basket—that ought to be in the passive basket, regardless of the wrapper that you put it in, which is a little bit tough in a corporate context, but certainly I would say that an MLP that owns real estate probably ought to passthrough the rental characteristic of it because I don't think you ought to sit there and say what the lawyers do, what label we put around it, ought to influence what basket it goes in.

Mr. TURLINGTON. Well, Mr. Chairman, I'd point out just briefly that of all of the issues that were debated by the New York State Bar Association in consideration of MLP's, the issue on which there was most consensus was this very issue: that all of us, virtually without exception, felt that, in keeping with the spirit and the intent of the passive loss rules and to raise the revenue that was necessary to keep the 1986 act revenue neutral, it was appropriate

and fair for MLP income to be taxed as portfolio income and not passive income.

Mr. ANDREWS. Let me—did you just—

Mr. KULLER. Well, no, I just—again, I think it's another one of those rules that it's a "heads I win; tails you lose" rule. That just smacks of unfairness and bad tax policy. The only way you can justify a rule like that is on a "get the money" approach. Here, probably, a "get the money" approach is justified.

Mr. ANDREWS. Do you all, from a practical experience, think that we could, as a Congress, legislate some other compliance of administrative measures that would make good sense?

Mr. McKEE. Yes. It seems to me that the one thing—when you have a young industry, if you will, MLP's, there's only 100 of them—you ought to take the opportunity not to structure your rules so that you collect the tax that you're supposed to get. Again, I would support Mr. Spiegel's comments which is you ought to discuss this issue with Mr. Nelson, the Chief Counsel of the Internal Revenue Service, come up with structure that the IRS—or a set of rules that the IRS feels comfortable with so that you can be sure you're collecting the revenues, and move forward.

I would also agree that I think you've gone a long way—that the insertion of section 6031(c) and in the technical bill that's pending, an appropriate penalty for failure to comply with the nominee reporting requirements, are going to improve the system a lot. But there's no question that some kind of entity level audit adjustments would be a major improvement.

There may be other steps that you feel that you want to take, and I don't think that the industry is going to complain if the rules are reasonable, I think everybody would like to see an efficient vehicle here. That's what those of us that support this form of entity believe in: an efficient way to collect one level of tax.

Mr. KULLER. I think it's important to point out that the way MLP's report now they are probably the most conservative reporting entity around, and that is because the cost involved if there are any audit adjustments, or any changes, is so huge that they make sure they dot all their "I's" and cross all their "T's" twice before they file their return.

Mr. ANDREWS. All of you disagreed with the revenue estimates of Mr. Mentz this morning, I believe, with the exception of Mr. Turlington.

Mr. HORTENSTINE. In the interest of full disclosure, we should tell you that all of us were involved in the group that hired economists to do our own revenue estimates. So I think we all disagree with Mr. Mentz' revenue estimates.

Mr. KULLER. And again, I don't—we're not revenue estimators. It's hard for us to come up here and say, "Well, we disagree with what the Treasury did," but we do have great faith in the work of Mr. Vasquez and Mr. Smith, and we think they are very, very experienced revenue estimators, and it is at least as likely that their number is right as any other number.

Mr. HORTENSTINE. Congressman Andrews, you'll have the benefit of Greg Ballantine's testimony in the morning, and he will take you through the economic analysis.

Mr. ANDREWS. Good. That was my question. We will have the benefit of your revenue estimates and the backup documentation.

Before we quit, I want to ask you all to comment on the resemblance test, because if you're right, Mr. McKee, that is a big, big problem, and I recognize we're going to hear a lot about that tomorrow, but I would like to just pose this as a general question to the panel: please make your comments about MLP's, vis a vis this resemblance test, the "duck" problem.

Mr. McKEE. To me, it's—the only logical argument that's been raised, which is a variation of the duck problem, is a variation of what I call the "level playing field" argument. That is: we've got a corporate tax. We ought to make the benefits or burdens on all similarly situated pools of capital the same. You've got to break that into two separate pieces.

The first is to say: existing owners of corporate capital ought to be treated the same as one of us tomorrow that invests in an MLP. We ought all be treated the same. I submit to you that that's the case already. If you go out and buy stock on the stock exchange tomorrow, the price that you pay is already fully discounted for the double tax. You're not going to pay a price based on a one-level tax when you know there's two, and the guy that sells it to you is going to know, you know, there's this adverse tax consequence to being a stockholder, and the price you pay reflects that. So there's no unfairness between people that currently own corporate stock—at least those that have bought it within our memories—and a group of us tomorrow that want to go out and invest in an MLP. We're all going to get the same aftertax yield.

The only real unfairness is from a corporation that has to issue new equity, and has to get that equity from the retail investor. The retail investor—if you want to go sell a new issue of corporate stock to the retail investor, you're going to have to pay a yield on that that reflects the double tax. You're going to have to—if you want to give him an 8 percent pretax and a 4 percent aftertax yield—assuming everybody's in the 50 percent tax bracket—the company would have to earn 16—assuming the old 50 percent days—they would earn 16, pay half of it to the Government, pay a dividend of 8. The guy that got the dividend of 8 would pay half of that to the Government, he'd get his 4 percent yield. That would be the same as a fellow that invested in MLP. MLP only has to earn 8 percent to give him the 4 percent yield.

So from that perspective, to the extent that you think corporate America is going out and competing with MLP's for new stock capital from the retail market place, there is a little bit of unfairness there. They've got to earn more on their capital than the MLP has to earn on its capital. But as everybody has testified today, except for Mr. Mentz, that's not what corporate America does. Corporate America, by and large, goes and gets either debt—which pays, at most, one level of tax—or it will oftentimes issue equity to tax exempt entities.

Again, a tax exempt investor that invests in corporate equity is having one level of tax. It pays no tax. So the corporation, in order to raise money from the tax exempt investor, only has to earn 8 percent to be able to pay 4 to the Government and give 4 to the tax-exempt investor if 4 percent after tax is what the market place

requires. So there is a small slice of unfairness in which the corporation that has to, for some reason, go to the retail investor is going to incur a higher cost of capital for that stock, as opposed to an MLP competing for the same dollar.

But the cost of eliminating that unfairness, which is a very small unfairness because a very small percentage of that capital that the corporate sector goes to get is actually done through stock from the retail investor, is to create its own unfairness, which is to say that the average small investor can't get access to passthrough taxation at all. He now has an unlevel playing field compared to his wealthy friend that is able to invest in equity investments in the partnership form.

So you can't have it both ways. I mean, If you want to eliminate that small slice of unfairness in the corporate sector, you're going to create, I suggest, a much larger piece of unfairness to the individual investors.

Our tax system is far too complex to ever get a perfectly level playing field for everybody. We've got too many goofy rules—the corporate double tax probably being the goofiest of them all—and, to me, we're much better with the MLP form and the slight unfairness, unlevel playing field, it creates, compared to the option which is, I think, a much less level playing field in terms of individual investors.

Mr. KULLER. Going back to the corporate resemblance test: the corporate resemblance test which currently exists in the Treasury regulations, dates back to a Supreme Court decision called *Morrissey*. In that case the Supreme Court laid out six factors which it thought were relevant in corporate resemblance, and we've lived with variations of that test and those six factors since then. I don't think anybody's suggesting they're perfect. What we're suggesting is that that corporate resemblance test is likely to be as good as anything that the Congress or the Treasury is going to come up with.

The idea that free trading should be a super characteristic—it reminds us of the limited liability company regulations when Treasury said limited liability should be a super characteristic. What is the next super characteristic on the horizon? It just seems to me that a partnership is no less a partnership when its interests commence trading; just like a corporation is no less a corporation when its interests cease trading.

If Treasury is so compelled by the trading characteristic, I wonder if it would be willing to allow nontraded corporations, regardless of how much income they generate, to enjoy passthrough treatment. I doubt that they would ever entertain such a suggestion.

Mr. HORTENSTINE. I think Bill's point is a very good one, and that is that such a small portion of U.S. investment is subject to the pure double-tax system, that the neutrality argument should be turned around and applied such that, to achieve true fairness and parity through a level playing field, an integrated or single-tax system should be imposed on the corporate sector. I continue to emphasize, though, as a practical matter, and that's the perspective I'm coming from, to the point that the disadvantages to operating in the partnership form in accessing institutional and foreign cap-

ital, both debt and equity, more than offset the one disadvantage of operating in corporate form in having a higher cost of capital.

I think an equilibrium or balance in the entity selection process presently exists.

Mr. TURLINGTON. Mr. Chairman, to summarize—I think your point was well taken that the purported duck argument against MLP's is that if something looks, walks, and quacks like a duck it must be a duck. Therefore, tax it as a duck. I also agree with what Mr. McKee said that perhaps it is a big duck, or perhaps a turkey argument.

To close, I submit to you, that if allowed to nurture properly, I believe these ducks, big ducks and turkeys, may all grow up to be swans, and that would be a very good thing for the system. [Laughter.]

Mr. ANDREWS. Anything for a laugh.

Mr. MCKEE. You could tell that one took a lot of work. We worked on that for an hour this morning.

Mr. ANDREWS. Thank all of you.

Our witnesses, once again, I have three names and I see four people sitting at the table, but our witnesses are: Robert A. Stanger, chairman of Robert A. Stanger & Co.; Christopher L. Davis, president, Investment Partnership Association; James F. Dickason, chairman of the board, Coalition for Publicly Traded Limited Partnerships. And you sir?

Mr. MORRIS. I am counsel for the Investment Partnership Association. My name, for the record, is William Morris, and I'm accompanying Mr. Davis.

Mr. ANDREWS. Thank you.

Mr. Dickason.

STATEMENT OF JAMES F. DICKASON, CHAIRMAN OF THE BOARD, COALITION FOR PUBLICLY TRADED PARTNERSHIPS, AND FORMER CHAIRMAN OF THE BOARD, THE NEWHALL LAND & FARMING CO.

Mr. DICKASON. Mr. Chairman, my name is Jim Dickason, and I've served for 14 years as chief executive officer of the Newhall Land & Farming Co., a publicly traded limited partnership. I'm also the chairman of the board of the Coalition for Publicly Traded Partnerships. The coalition is a trade association composed of publicly traded partnerships and those who work with them.

I am here to tell you the positive news about PTP's, the news you may not have found in the Treasury Department policy statements, or the reports in the press. Contrary to public opinion, publicly traded partnerships are not being formed primarily as a tax avoidance mechanism. They are a capital formation tool, and, in my experience, an extremely good one.

I want to talk to you, based on my experience, and that of my fellow coalition members, about the reasons we have chosen to form PTP's, and why you should not consider us a threat to the Federal revenue base. In addition, although I'll leave the technical details to the accountants and attorneys who will be testifying before and after me, I'd like to say that we are making every effort to achieve compliance with the tax laws, it's important for us to—

and I believe we're making great progress in this area. As a matter of fact, we've been pioneers in the computer programs for partnership accounting.

Let me start with the candid admission that up until the end of last year there were corporations that liquidated and converted to PTP's with the primary aim to escape corporate level taxation. I might mention at this point that these corporations and their shareholders paid a substantial toll charge in the form of recapture and capital gains taxes for the privilege of converting to PTP's.

In our own case, we paid \$100 million—pre-paid \$100 million in taxes, and we had \$4 million in administrative costs in order to make that change. But these liquidations have now been shut down by the repeal of *General Utilities*, and even while that was going on, the resulting PTP's were a small portion of the total number—we estimate 1/6 of the PTP's in existence as of the beginning of this year.

The vast majority of existing PTP's have been, and virtually all future PTP's will be, created primarily for nontax reasons. In our case the market value of our investment has increased threefold, and the trading volume has increased eightfold, since we became a publicly traded partnership. This can be seen at how the different types of PTP's in the coalition were formed. This examination will also shed some light on the revenue.

I'm not going to talk about rollups because rollups have no impact on revenue since they didn't pay any tax before, and they don't pay any tax now. But rollouts—the largest group of PTP's consist of those that have been rolled out of existing corporations. Typically the corporation places a group of its assets into a PTP, and, in return, receives partnership units, which it either sells to the public or distributes to its shareholders.

I do not know of any rollouts that were done entirely for tax reasons; rather, the transactions were also done for such reasons as to raise additional capital without incurring debt while still retaining control of assets, to retire existing debt, to segregate and highlight undervalued assets so as to enhance the market value, and to make hostile takeovers more difficult.

If I leave you with no other impression today I want to leave you with this one: PTP's are an important capital formation mechanism. It is my belief that they are a capital formation tool that is better for the economy and less costly in terms of revenue than traditional debt financing.

Let me turn to Treasury Department's principle concern: that new businesses will be organized as PTP's rather than corporations. The fear is that this will deprive the Treasury of potential corporate revenue which it might otherwise have collected.

When we met with Mr. Mentz in mid-1986, I heard a prediction from him that 300 PTP's would be formed in 1986, and 3,000 would be formed in 1987. I think he's slightly off the mark. Since only about 100 PTP's have been formed to date, it appears that both the attraction of this business form, as well as the threat to the corporate tax base, have been grossly exaggerated.

Business still chooses the corporate form in overwhelming numbers. In 1986, for example, Mr. Mentz said that 5 percent of the capital raised was raised through limited partnerships, but only

eight-tenths of 1 percent was raised by publicly traded partnerships.

It is perhaps understandable, given the widespread use of non-traded partnerships as tax shelters, that people would reflexibly assume that publicly traded partnerships must be tax shelters as well. Well, that isn't the case.

I hope that you'll accept this innovative new approach to capital formation, turn your attention elsewhere, and leave PTP's to go about their own business.

As of the end of 1986, 34 percent of the PTP's were in oil and gas, and 39 percent were in real estate—a total of 73 percent—two areas in which the Treasury proposes alternate passthroughs.

From a public policy point of view, changing the tax treatment of PTP's would be devastating because it would lock out small investors from participating in some of the most interesting and profitable opportunities in the economy. The participation of small investors in capitalizing our economy is one of the surest ways of achieving a share in America.

[The prepared statement of Mr. Dickason follows:]

TESTIMONY OF JAMES F. DICKASON
CHAIRMAN OF THE BOARD
COALITION FOR PUBLICLY TRADED PARTNERSHIPS

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
June 30, 1987

My name is James Dickason, and I have served for 14 years as the Chairman of the Board of the Newhall Land and Farming Company. I am also the Chairman of the Board of the Coalition for Publicly Traded Partnerships. The Coalition is a trade association comprised of publicly traded partnerships (PTPs) and those who work with them. It began in 1983 as an informal group and has been active in legislative and other issues affecting PTPs since then.

I am here to tell you the positive news about PTPs, the news you may not have found in the Treasury Department policy statements or the reports in the press. Contrary to popular opinion, publicly traded partnerships are not being formed as a tax avoidance mechanism. They are a capital formation tool--and in my experience, an extremely good one. They are not going to erode the federal revenue base--in fact, they may pick up some revenue. Their resemblance to corporations is purely superficial. And they do comply with the tax laws.

I want to talk to you, based on my own experience and that of my fellow Coalition members, about the reasons why we have chosen to form PTPs and why you should not consider us a threat to the federal revenue base. In addition, although I'll leave the technical details to the accountants and attorneys who will be testifying before you, I'd like say that we are making every effort to achieve compliance with the tax laws--it's important to us and I believe we're making great progress in this area.

Why PTPs are Formed

Let me start with a candid admission that up until the end of last year there were in fact some corporations that liquidated and converted to PTPs. For many or most of these corporations, the primary aim was to escape corporate level taxation. I might mention at this point that these corporations and their shareholders paid a substantial toll charge in the form of recapture and capital gains taxes for the privilege of converting to a PTP. These liquidations have now been shut down by the repeal of General Utilities. And even while they were going on, the resulting PTPs were a small portion of the total number--we estimate about one-sixth of the PTPs in existence as of the beginning of this year.

The vast majority of existing PTPs have been, and virtually all future PTPs will be, created primarily for non-tax reasons. This can be seen by looking at how and why the different types of PTPs in the Coalition were formed. This examination will also shed some light on the revenue question.

Let's look at how and why the different PTPs are formed.

Roll-ups

Some PTPs, such as Apache Petroleum Company, have been "rolled up" out of several smaller, non-traded partnerships. Common sense will tell you that these PTPs could not have been formed to escape double taxation--there wasn't any to escape. Rather, these PTPs were formed to enable their managers to reach a larger segment of the capital market. By allowing partnership interests to be purchased in small, easily traded units, they

were able to reach the smaller investors who could not afford the large investment and long-term commitment of funds required by traditional limited partnerships. In addition, by combining several smaller partnerships into one larger one, they were able to realize administrative efficiencies and economies of scale.

These transactions obviously did not cost the Treasury any corporate tax revenue; none was being paid to begin with. Each roll-up has brought the Treasury a short-term revenue windfall due to recapture and loss of percentage depletion. And in the long run, roll-ups should prove to be revenue enhancers, as partnership interests will be transferred and capital gain realized far more frequently than in the non-traded partnerships.

Roll-outs

The largest group of PTPs consists of those that have been "rolled out" of existing corporations. Typically, the corporation places a group of its assets into a PTP and receives in return partnership units, which it either sells to the public or distributes to its shareholders.

I do not know of any roll-outs that were done primarily for tax reasons. Rather, the transactions were done for such reasons as:

- To raise additional capital without incurring debt or diluting shareholder equity, while still retaining control of assets

- To retire existing debt

- To segregate and highlight undervalued assets so as to enhance their market value; and

- To make hostile takeovers more difficult.

Again, Treasury will realize a one-time revenue windfall when each roll-out occurs. The corporation will be subject to capital gains realization and recapture when it sells or transfers its PTP units, and shareholders receiving a distribution of PTP units will be taxed as if they had received a dividend.

As for the long-term revenue effect of a roll-out, I urge you to keep in mind the probable alternative to each of these transactions: debt--additional debt piled onto a corporate economy that is already choked with it. Debt which will deprive the federal Treasury of a great deal of corporate revenue due to interest deductions which, because of the high proportion of tax-exempt investors in corporate capital markets, often will not be matched by corresponding taxable interest income (virtually all PTP unitholders, on the other hand, are taxpaying individuals).

Keep in mind also that the corporate general partner will usually retain a significant interest in the PTP it has rolled out. Partnership income that is flowed through to the corporation will of course be taxed at the corporate level, and taxed again when it reaches the corporate shareholders.

If I leave you with no other impression today, I want to leave you with this one PTPs are an important capital formation mechanism. It is my belief that they are a capital formation tool that is better for the economy and less costly in terms of revenue than traditional debt financing.

Initial formations

Finally, let me turn to what I understand is the Treasury Department's principal concern: that new businesses will be organized as PTPs rather than as corporations. The fear is that this will deprive the Treasury of potential corporate tax

revenues which it might otherwise have collected.

For instance, when I met with Treasury officials in mid-1986, I heard a prediction that 300 PTPs would be formed in 1986 and 3,000 would be formed in 1987. Since only about 100 PTPs have been formed to date, it appears that both the attraction of this business form as well as the threat to the corporate tax base have been grossly exaggerated.

If you look at initial formation PTPs, you will find that the great majority of them are in industries, particularly real estate, that have traditionally raised capital through limited partnerships. And my prediction is that if you shut down PTPs, these businesses will simply raise capital through traditional limited partnerships. This would probably result in a reduction in the amount of revenue Treasury would realize over that realized through a PTP, if for no other reason than that interests in traditional partnerships are illiquid and thus produce taxable capital gains only infrequently.

It should also be noted that if the current tax treatment of PTPs is changed, it will be the small middle class investor who will be hurt.

If the business does not go the limited partnership route, it may use a REIT or a REMIC, or perhaps a highly leveraged corporate structure. Whichever alternative is chosen, it is doubtful that it will generate any more tax revenue than would a PTP.

Corporate Resemblance

I don't want to delve into all the technicalities of classification in this statement, but I would like to reiterate my belief, and that of the Coalition, that any classification scheme that relies on size and public trading as the criteria for distinguishing corporate from partnership tax treatment is simply wrong.

First, despite the fact that tradeability is one of the "corporate" characteristics considered under the current regulations, it is not in fact an inherent or a significant characteristic of corporations. The great majority of corporations are closely held and not publicly traded. It is also a very fuzzy concept, as there are syndicated partnerships the interests in which are not listed on public exchanges but for which a significant informal market has grown up. The use of size as a determinant is similarly flawed, as many corporations are very small and many non-traded partnerships are very large.

While the apparent resemblance of PTPs to corporations based on size and tradeability is misleading and superficial, the many differences between PTPs and corporations--and the similarities between PTPs and other partnerships--are very real. Unlike corporations, but like other partnerships, PTPs have a general partner whose assets are exposed to the liabilities of the partnership; have a limited term of existence and are subject to termination upon the occurrence of any of several events, such as the death or bankruptcy of the general partner; do not offer their investors complete limited liability; subject their investors to taxation on partnership income whether or not it is distributed to them; are effectively off limits to major institutional and foreign investors; and are governed by the vagaries of state partnership law.

Businesses operating as corporations have chosen to pay a corporate tax in return for the many advantages conferred by incorporation. PTPs, like other partnerships, have chosen to forego these benefits. There would thus be precious little equity in imposing a corporate tax on them.

Choice of Business Structure

Besides the questions of why PTPs are formed and what their revenue implications are, I believe that there is a fundamental issue underlying this debate: should we or should we not allow business owners to raise capital in the manner that makes the most economic sense for their particular business concern?

Businesses have chosen the corporate form in overwhelming numbers. In 1986, for instance, only 3.7% of the capital raised in this country was raised through limited partnerships. Only 0.8% was raised through PTPs.

But if some of that small percentage that have chosen to operate in partnership form wish to enhance their efficiency and expand their range of potential investors by offering their partnership units for public trading, should they be denied this right because the public trading of their unit gives them a superficial resemblance to a corporation? Or if a corporation wishes to avoid overburdening itself with debt and to try a creative and possibly more economically efficient way of raising new capital, should it not be allowed to do so? And why should we penalize the small investors who purchase PTP units while allowing the wealthy to invest in private syndications?

As one who has been in business for over 40 years, I can tell you that when we decide to raise capital, we look at the bottom line. We're not going to enter into any transaction unless it makes good economic sense. And while taxes are always one factor that must be considered in that equation, they are not, as I hope I've demonstrated, the primary one in deciding whether to form a PTP.

I might add that the fact that partnerships can trade is a tribute to our efficient markets and the marvelous developments made in information technology. These are innovations of which we should be proud.

It is perhaps understandable, given the widespread use of non-traded partnerships as tax shelters prior to tax reform, that people would reflexively assume that publicly traded limited partnerships must be tax shelters as well. Similarly, any variation on a traditional form of doing business is looked upon with suspicion by policymakers, who ask themselves why the business managers are deviating from the norm and conclude that they must be doing so for tax avoidance purposes. If a few cases arise where tax considerations actually are the motivation, there is a tendency to assume, incorrectly, that this is true in every case.

With all due respect, I suggest that if you go beyond the reflexive reactions and examine the evidence, you will find that the evidence does not show that publicly traded limited partnerships are primarily motivated by tax avoidance, that they are a drain on the federal revenue, nor that they are any less beneficial to the economy than other means of raising capital. And if this is the case, I would hope that you could accept this new approach to capital formation, turn your attention elsewhere, and leave PTPs to go about their business.

From a public policy point of view, changing the tax treatment of PTPs would be devastating because it would lock out small investors from participating in some of the most interesting and profitable opportunities in the economy. The participation of small investors in capitalizing our economy is one of the surest ways of achieving a share in America.

THE COALITION FOR PUBLICLY TRADED PARTNERSHIPS

Airlease, Ltd.
American Finance Group
Andrews & Kurth
Angell Care M.L.P.
Apache Petroleum Company
Arthur Andersen & Company
Bankers Trust
Commonwealth Mortgage of America, L.P.
Computer Language Research
Coopers and Lybrand
Dean Witter Reynolds
Emerald Homes, L.P.
E.F. Hutton & Co., Inc.
Intelligent Systems Master, L.P.
Interstate General Company, L.P.
IP Timberland, Ltd.
Manufacturers Hanover Trust
Motel 6, L.P.
National Healthcorp, L.P.
The Newhall Land and Farming Company
NVHomes, L.P.
Peat Marwick Main & Company
Petrolane Partners, L.P.
Pope Resources
Price Waterhouse
Rayonier Timberlands, L.P.
Service Master Limited Partnership
Southwest Realty, Ltd.
Wilmer, Cutler & Pickering

Chairman RANGEL. I apologize to the witness. We serve on different subcommittees, and as the various chairmen need forms in order to proceed with the limited time that we have for hearings, we're forced to play musical chairs. But I'll stay with you as long as I can.

Have we finished the presentations of the testimony here?

Mr. DAVIS. Two more to go, Mr. Chairman.

Chairman RANGEL. Mr. Stanger, you've testified?

Mr. DAVIS. No, Mr. Dickason is finished. Now it will be my turn.

Chairman RANGEL. Mr. Davis?

Mr. DAVIS. Right.

STATEMENT OF CHRISTOPHER L. DAVIS, PRESIDENT, INVESTMENT PARTNERSHIP ASSOCIATION, ACCOMPANIED BY WILLIAM MORRIS, COUNSEL

Mr. DAVIS. Thank you, Mr. Chairman.

I'm Christopher Davis, president of the Investment Partnership Association. I am accompanied by William Morris, our counsel, who is with the law firm of Rogers & Wells.

The Investment Partnership Association is the national organization of investors and sponsors involved in all forms of partnerships. Our association's technical task forces, made up of people with extensive partnership experience, are eager to be a resource to the subcommittee and its staff in developing solutions to any technical and compliance problems that may be found.

The work of our consultants, including recently developed materials from Townsend-Greenspan, will be available to you, and, Mr. Chairman, I would ask your permission to have these materials be made part of the record.

Chairman RANGEL. Without objection.

[The following was subsequently received:]

Partnerships In America

A Study by Townsend-Greenspan & Co.

LIMITED PARTNERSHIP ANALYSIS

EXECUTIVE SUMMARY

Townsend-Greenspan & Co., Inc. has undertaken a comprehensive and detailed study of the traditional investment partnership, covering the years 1983 to 1985. Our analysis is based on the only reliable data source that yields full coverage, namely the Internal Revenue Service data system.

Reporting to the IRS in 1985 were 280 thousand limited partnerships, with nearly 8 million partners and \$636 billion in total assets. The number of partnerships increased briskly between 1979 and 1985, at a rate greater than 12% per year, and the size of the average partnership also has grown. The total number of partners in limited partnerships increased at a rate exceeding 20% per year between 1979 and 1985, and total assets of all limited partnerships expanded at a better than 25% per year rate.

These overall statistics indicate that investment partnerships have been a dynamic part of the U.S. economy in the 1980s. The number of limited partnerships has grown significantly faster than has real GNP. Also, real capital formation increased substantially more in 1984 and 1985 under limited partnerships as a whole than under other forms of business organization. Finally, new equity capital raised by investment partnerships in 1984 and 1985 was significantly larger than the new capital raised by initial stock offerings of corporations in those years.

Further analysis makes it clear that limited partnerships were not all alike, however. The industry sector of a partnership, its size, and whether or not the partnership was profitable all dramatically affected its business characteristics during the 1983 to 1985 period. Comprehensive data for 1986 and 1987 are not yet available, of course, and the limited partnership sector has been profoundly altered by the Tax Reform Act of 1986. Since our analysis is detailed as well as comprehensive, however, it is possible to isolate those limited partnerships apparently designed for tax reduction from those that represent sound and well-run businesses. The business characteristics and trends for the latter category are likely to be increasingly important, as tax reform has eliminated the important supports for the former category.

Small Real Estate Limited Partnerships Dominate the Totals

Our most significant finding is that aggregative data, for which there has been so much publicity, are heavily affected by huge losses in small real estate limited partnerships (50 partners per partnership or less). Over 90% of the total book net losses of all limited partnerships were reported by small limited real estate partnerships, and this class amounts to just over one-third of all limited partnerships and less than one-sixth of all partners. Losses reported by large real estate partnerships, with more than 1000 partners per partnership, were much smaller. Large partnerships, excluding real estate, broke even in 1985 and were profitable in both 1983 and 1984.

Size differences are stark when judged by total assets per partner. Large partnerships are obviously larger. At \$33 million in assets per partnership, they were more than 20 times the \$1.8 million average for small partnerships. The total assets of large partnerships were only about \$10 thousand per partner, however, while small partnerships, on average, showed \$150 thousand in assets per partner. These differences reflect a concentration of asset holdings by a few investors for small partnerships, in contrast to much more broadly based holdings for large partnerships.

Similarly, the high debt leveraging of real estate partnerships almost completely determines the rather high five to one ratio of debt to equity for all limited partnerships. High ratios of debt to equity are a potential problem for American business as more highly leveraged firms may be threatened if interest rates were to increase substantially or the business cycle turns down. Excluding real estate produces a benign one to one debt/equity ratio, however, and our analysis indicates a clear tendency for debt/equity ratios to decline as the partnership size increases.

Large Limited Partnerships Differ Dramatically from Others

Large limited partnerships, with more than 1000 partners each, have generally been more profitable. In fact, profitable partnerships tend to have a significantly larger number of partners per partnership than do deficit partnerships overall.

Furthermore, equity played a much larger role in the financing of the expansion for large partnerships during 1983-1985, and their liquidity positions are far stronger. Between 20% and 25% of net new equity funds raised in 1984 and 1985 (including earnings retained by partnerships) were raised in large partnerships, although these large partnerships accounted for only 5% of total limited partnership assets during these years.

Overall, limited partnerships with more than 1000 partners have balance sheets that show modest debt/equity ratios, reasonable levels of liquid assets or current assets in relationship to current liabilities, and adequate working capital. On the whole, large limited partnerships had balance sheets and income statements indicating well-run operations, even when incentives still existed to generate losses for tax purposes.

Limited partnerships are clearly an important form of business organization, and they produced significant capital investment during the period of analysis. Net fixed assets of all limited partnerships increased 31% in 1984 and 22% in 1985, two years during which net fixed capital formation in the economy as a whole increased by 19% and 6%. Limited partnerships raised nearly \$25 billion in equity funding through partner capital accounts in 1985, and large limited partnerships especially have a particular attraction for equity financing, an important attribute in today's highly leveraged business system.

LIMITED PARTNERSHIP ANALYSIS

GLOBAL CHARACTERISTICS OF LIMITED PARTNERSHIPS

For the year 1985, 280 thousand limited partnerships with 7.9 million partners and \$636 billion in assets reported to the Internal Revenue Service.

Partnerships have been an integral part of American business enterprise since Colonial days, and the number of partnerships continued to expand during the twentieth century, especially to undertake projects and to provide services that would have been overlooked or dismissed by other forms of business organization.

As indicated in the table below, limited partnerships have been growing at a significant rate in the 1980s.

Some of the reasons for this growth were outlined in a recent Internal Revenue Service publication. "As a type of business entity, the partnership affords compelling opportunities as an investment vehicle not found in either the corporation or the sole proprietorship. Since the partners and not the partnership are taxed on partnership income, the so-called 'double-taxation' of corporate activity (by which the corporation is taxed on its income and shareholders on their dividend distributions) is avoided.

The partnership also provides an excellent means for obtaining quantities of capital sufficient to achieve economies of scale and discount purchases not acces-

	Limited Partnerships		
	1979	1983	1985
Number of Partnerships (thousands)	136.1	234.0	279.9
Number of Partners (thousands)	2352	5435	7914
Total Assets (\$ billions)	154.6	472.6	636.2

Between 1979 and 1985, the number of limited partnerships more than doubled, a percentage change of nearly 13% per year.

The size of each partnership also has been expanding. The total number of partners involved increased more than 20% per year, from 2.3 million in 1979 to 7.9 million two years later. The total size of limited partnerships has increased even more quickly, from total assets of \$155 billion in 1979 to \$636 billion in 1985, a growth rate exceeding 25% per year.

sible to the smaller and accordingly more restricted sole proprietorship. In fact, the limited partnership offers an ideal form to obtain infusions of investment capital since, while one or more general partners control and direct business operations, the 'limited' partners function much as shareholders in a corporation. While their liability is limited to the amount of their individual investments, they can share, nevertheless, directly in the partnership's gains and losses since, unlike the corporation, the partnership is not taxed on its income prior to distribution. Thus, additional partners can be obtained to increase the 'size'

and also the earning potential of the partnership itself."

Limited partnerships also are changing rapidly, especially as master limited partnerships begin to increase in number. This study focuses on traditional forms of limited partnership, however, by concentrating on data for the period ending in 1985. Data for 1986 are not yet available, and these data will presumably be affected by the early responses to the Tax Reform Act of 1986. Nevertheless, the characteristics of these firms during the 1983-1985 period afford us a fairly reliable insight into the structure of traditional limited partnerships.

Limited partnerships are not only an important form of business organization, but they also play a key role in the expansion of the American economy. One of the most striking characteristics of limited partnerships is the heavy level of capital investment. Net fixed assets of all partnerships increased by 31% in 1984 and then by 22% in 1985, for example. In the same two years, total net fixed capital formation as a whole increased by 19% and 6% (in nominal terms), indicating a notably more rapid pace of fixed investment by firms organized as limited partnerships.

Furthermore, limited partnerships, and large limited partnerships especially, have a particular attraction for equity financing, an important attribute in today's highly leveraged business environment. The net increase in partners' accounts during 1984 was \$11 billion; in 1985 the total amounted to almost \$25 billion. (Indeed, the 1985 increase would have been more than \$28 billion if it were not for liquidations by real estate partnerships.) In both years, the new capital raised by limited partnerships was significantly larger than the new capital raised by initial public stock offerings by corporations.

Differentiation of Limited Partnerships

This study is concerned specifically with *limited* partnerships, among all partnerships, and is particularly concerned with the differences between limited partnerships in different industry sectors and between the smallest and largest limited partnerships.

The number of limited partnerships comprised less than 16% of all partnerships in 1984, but they were clearly the more important component. The average limited partnership is 5 to 6 times the size of the average for other than limited partnerships, as judged by number of partners or total assets. Limited partnerships therefore represent nearly 54% of all partners and 46% of total partnership assets.

Limited partnerships have been traditionally organized to fund oil and gas extraction, low-income housing and housing rehabilitation, and a wide variety of services. Our analysis of the 1983-1985 location of limited partnerships shows that their assets were indeed disproportionately located in real estate, oil and gas extraction, holding and investment companies and a wide variety of services including equipment rental and leasing, motion picture production, distribution and a variety of other services.

Real estate accounted for 58% of all limited partnership assets in 1985. Financial partnership assets were 24% of the total; other services accounted for about 7%, and mining for about 5%. Collectively, all other partnerships represented only about 5% or 6% of all limited partnership assets, with the largest of the other standard industry categories (agriculture, forestry, and fishing) amounting to no more than 1%. Limited partnerships were sparse in printing and publishing and virtually nonexistent in the rest of manufacturing.

Most limited partnerships are quite small, as measured by either number of partners or total assets. Fully 75% of the total end-1985 assets of all limited partnerships were found in partnerships with no more

than 50 partners, and the average number of partners in this class was less than 12. Only 5% of total assets were held by the largest limited partnerships, those with more than 1000 partners. The partnerships with 51-100 partners accounted for 9% of total assets, those with 101-500 partners for 7%, and those with 501-1000 partners accounted for 5%.

The comparison of the smallest and largest partnerships makes it very clear that not all limited partnerships are alike. More than 96% of all limited partnerships contained 50 partners or fewer in 1985, but the average size was such that these "small" partnerships contained only about 40% of all partners. In contrast, only 0.3% of all partnerships had greater than 1000 partners, but the size of these operations was so substantial that these "large" partnerships accounted for a comparable 42% of all partners. Thus, these two classes were roughly comparable judged by the number of partners.

What is particularly striking, however, is the difference in assets per partnership and per partner. The average small limited partnership had about \$1.8 million total assets in 1985, or approximately \$150 thousand per partner. However, large limited partnerships were almost 20 times the size of small limited partnerships, with \$33.4 million assets per partnership on average in 1985. But these consisted of a larger number of much smaller investments. Total assets came to less than \$10 thousand per partner within partnerships consisting of more than 1000 partners. The difference reflects a concentration of asset holdings by a few investors for small partnerships, in contrast to much more broadly based holdings for large partnerships.

We conclude that an analysis lumping all limited partnerships together is inappropriate, and the key to understanding the realities of limited partnerships is dependent on distinguishing them not only by size but also by industry. There are two clear types of limited partnerships; small (less than 50 partners) real estate

partnerships and all others. Small real estate limited partnerships are so many in number, and the amounts at stake per partner are so much larger, that overall statistics for all limited partnerships are essentially statistics for this subclass alone.

The remainder of this section of the study shows how the statistical description of all limited partnerships is so heavily influenced by the small real estate limited partnership subclass. The following section then turns to an examination of the salient characteristics of large (more than 1000 partners) limited partnerships to provide both contrast and an understanding of how limited partnerships other than the small real estate partnerships actually operate.

Small Real Estate Limited Partnerships

The most significant finding of our study of limited partnerships during the years 1983 through 1985 is that the aggregative data, for which there has been so much publicity, were heavily affected by the huge losses in some small limited real estate partnerships. These were the partnerships which, in many but not all cases, reflected large tax losses.

It is important to note, however, that book net income or loss data exclude realized capital gains accruing directly to the partners. Realized capital gains for real estate operations have often approached, and sometimes exceeded, the book net loss in recent years when real estate prices increased sharply. Therefore, limited partnership losses generally have tended to be overstated.

Nevertheless, all limited partnerships reported a total book net loss of \$26.9 billion to the IRS in 1985. The 159 thousand real estate partnerships, however, with fewer than 50 partners per partnership (averaging 11.6 partners), reported losses of \$18 billion in that year.

Furthermore, only about two-thirds of these partnerships were unprofitable. The class of all small real estate partnerships included 107 thousand partnerships reporting losses of \$24 billion, partly offset by 52 thousand profitable partnerships that achieved \$6 billion in net income. Small deficit real estate partnerships therefore accounted for over 90% of the total \$27 billion deficit.

If one were to extract these small real estate partnership operations, with their tax shelter focus, the remaining limited partnership activity obviously would be marginally profitable. Large partnerships, those with more than 1000 partners and excluding real estate, broke even in 1985 and were profitable in both 1983 and 1984. These data, as previously mentioned, exclude capital gains and losses.

The impact of the sizable debt leveraging of real estate limited partnerships also created a rather large five to one ratio of long-term debt (including non-recourse loans) as a ratio to partners capital for all limited partnerships in 1985. Since high debt/equity ratios could be a potential problem for American firms, if interest rates were to increase substantially or

the business cycle turns down, increasing concern has been expressed about debt/equity ratios in general. Based on aggregate data, limited partnerships would most likely be regarded as an example of this potential problem. Excluding real estate, however, the debt/equity ratio falls to a rather benign one to one.

In contrast, the debt/equity ratio for all real estate partnerships is much higher and has increased substantially, from about 28 to one in 1983 to over 100 to one in 1985. Indeed, for small real estate partnerships the debt/equity ratio no longer makes sense. Partner capital accounts have been driven to zero and beyond; thus they show a deficit rather than positive equity position.

It is also important to note that, as the limited partnership sector of the economy has expanded rapidly, limited partnership debt/equity ratios have been falling. This is true at the aggregate level, where debt/equity ratios declined from 6.1 to one in 1983 to 5.1 to one in 1985, among larger partnerships (0.56 to one in 1983 to 0.46 to one in 1985), and among large real estate partnerships (0.80 to one in 1983 to 0.71 to one in 1985).

SPECIAL ATTRIBUTES OF LARGE LIMITED PARTNERSHIPS

In 1985, there were 953 partnerships with more than a thousand partners, comprising 3.3 million partners. When we concentrate our analytical study on these large partnerships, we observe far more profitable income producing organizations with significantly less emphasis on the form of tax avoidance that appears to characterize smaller real estate partnerships.

Profitability and Size

More than half the assets in large partnerships were in profitable units during the period of this analysis, and these accounted for about three-fifths of all partners. The net loss in the larger partnerships was only \$1.0 billion in 1985 and only \$339 million and \$158 million in 1983 and 1984, respectively. This compares to a total book net loss at nearly \$27 billion for all limited partnerships taken together.

Profitable partnerships were somewhat larger in 1985 than deficit partnerships, measured by the average number of partners per partnership. For example, profitable mining partnerships exhibited a hundred partners per partnership on average, compared with the overall average of 70 partners per mining partnership.

The effect of average partnership size is particularly pronounced among the largest operations. Those partnerships with more than a thousand partners averaged 3,481 partners per partnership in 1985. The average was 4,070 partners per partnership for large partnerships with net income, however, and only 2,864 partners for deficit partnerships. The profit making mining partnerships averaged 3,950 partners for the more than thousand group, but only 2,081 for those with losses.

Large real estate partnerships exhibited much the same pattern in 1985 with 4,902 average partners for profitable partnerships, only 3,387 for those with losses.

Profitable finance partnerships were also significantly larger than deficit partnerships.

In short, profitable partnerships, on average, tended to have a significantly larger number of partners per partnership than did deficit partnerships. There are some industries where deficit partnerships were larger than profit-making partnerships, but these were in the areas where limited partnerships tended to be sparse, with little presence in their industry. However, the quality of the data in these cases may be suspect. Since there are very few partnerships involved, the percentage sampling error in the IRS data could be substantial.

Business Characteristics and Size

Large partnerships had assets of \$32 billion in 1985, spread over 3.3 million partners, or about a \$9,600 investment per partner. As noted above, this is dramatically smaller than the per partner investment of small limited partnerships. Furthermore, the average investment per partner has been declining, although slowly, from an average just over \$10,000 per partner in 1983 to about \$9,600 per partner in 1985.

Of the \$32 billion total assets of large partnerships in 1985, \$20 billion was financed by partners equity. Partners' capital accounts rose from \$11.5 billion at the end of 1983 to \$20.0 billion at the end of 1985, for partnerships with more than 1,000 partners, an increase of 75%. In other words, partners accounts rose from 59% of assets at the end of 1983 to 63% of assets at the end of 1985. It is not surprising, therefore, that debt equity ratios fell from a modest 0.56 to one in 1983 to a still lower 0.46 to one at the end of 1985.

Mining limited partnerships, largely oil and gas extraction, had partners capital accounts at the end of 1985 that represented 86% of assets and, as a consequence, showed negligible debt, though exhibited less favorable liquidity ratios than all the large partner-

ships. Finance partnerships were almost as equity prone with 79% of assets financed by partners capital by the end of 1985.

Even the large real estate limited partnerships, where debt to equity ratios were higher than other large partnerships, nonetheless, financed 54% of total assets with equity, and this was true despite their very large use of nonrecourse loans as a means of financing.

Liquid assets of large partnerships were a consistent two times current liabilities throughout the three year period, and current assets ranged from 3.3 to 4.4 times current liabilities. Net working capital rose by 35% over the period and ranged from 12% to 15% of total investment.

Business receipts were \$1.5 billion for large limited partnerships in 1985, and capital investment was substantial. These partnerships increased net fixed assets by 28% in 1985, although the increase in 1984 was only 12%. Gains were particularly pronounced in 1985 for oil, gas, and other mining, where net fixed assets increased 65%, more than double the rate for other partnerships. Net assets in large service partnerships doubled, and very substantial gains were evidenced in cable television and other communications.

The ability of large limited partnerships to raise equity funds also was noteworthy. The estimated \$3.0 billion for 1985 capital investment in large partnerships, coupled with an \$0.6 billion increase in working capital and a \$4.7 billion increase in other assets, implies these partnerships were required to finance a total of \$8.4 billion. This total was financed largely by net new equity funds raised, which amounted to \$6.3 billion. Long-term debt added \$1.5 billion and depreciation and depletion accounts, \$0.4 billion.

Indeed, although large partnerships accounted for only 5% of total assets of all limited partnerships at the end of 1985, more than a fourth of net new equity funds raised by all limited partnerships were raised in

the larger partnerships. One-fifth of all net new equity was raised in large partnerships in 1984.

The Trend Toward Large Partnerships

The size of the average limited partnership has risen from approximately 17 partners in 1979 to 28 in 1985. Although the vast number of small partnerships makes these averages quite modest, an increase from 17 to 28 is actually very substantial. To put it another way, there were 20% more small limited partnerships in 1985, compared with 1983, but fully 87% more large limited partnerships in 1985 compared with 1983 levels. Alternatively, the number of partners in small limited partnerships increased 46% between 1983 and 1985, but the number of partners in large limited partnerships increased 72%. By almost any measure, therefore, limited partnerships tended to become larger.

Across industry segments, of course, the average size varied considerably. Mining partnerships were the largest, with about 70 partners per partnership, and the few partnerships classified as communication and electric, gas, and sanitation services were also typically larger than average, about 35 partners per partnership. The partnerships in manufacturing and in wholesale and retail trade were much smaller, averaging only about 5 partners per partnership. Even within these sectors, however, the general tendency has been for the average size of each partnership group to increase as the number of large partnerships expands faster than the number of small partnerships.

This is particularly important since we have found that large limited partnerships are generally more profitable, that equity played a much larger role in financing their expansion and that their liquidity positions were far stronger. The trend over the period 1983 to 1985, therefore, indicates a movement toward limited partnerships that exhibit balance sheets indicating well run operations rather than tax avoidance.

APPENDIX A: DATA AND METHODOLOGY

Although there are considerable fragmentary data available on limited partnerships, from individual balance sheets and partnership income statements, the only reliable source that yields full coverage rests with the Internal Revenue Service's data system. IRS publications covering partnership data, however, focus on all partnerships, with only small excerpts of data on limited partnerships. This makes it impossible to focus on limited partnerships in isolation while still relying on the best data sources.

For the express purpose of this analysis, data were obtained from the IRS that covered limited partnerships only, for the years 1983, 1984 and 1985. This permits the first thorough analysis of specifically limited partnerships to be executed. In addition, the industry and size breakdown of this raw data also permit an analysis that can identify the very different character of limited partnerships that are in different industries and the important differences between large partnerships and small ones.

Raw Data Summary

As usual, the IRS edited the tapes in a manner that deleted all numbers from which disclosures of individual partnership returns could be possible. Although the excised data imply that certain averages, ratios, and other valuable statistics cannot be obtained, it turns out that recreating a very close approximation of the important excised data is possible, with some work, and appears to be reliable.

The reason for this is that deleting some "small" category is accompanied by a corresponding deletion of an adjoining "large" category. (Otherwise, one could simply retrieve the excised data by subtraction, given the total and all other components.) Since we know, based on the totals, that the small category is essentially negligible, it follows that a fairly accurate estimate of the corresponding large category can be based on the totals. The resulting estimates are then

reliable for the important components, although the estimates of the small categories, those that the IRS is attempting to protect, may not be reliable. For purposes of this analysis, however, these peripheral categories are not important. The technical aspects of this are explained more thoroughly below.

Raw data are available for all limited partnerships and for those with net income. The data for partnerships without net income can obviously be derived by subtraction, assuming that neither the total partnership figures nor the profitable partnership figures have been excised. This is an example of why it is important to make estimates for missing data, since one piece of missing information makes all "downstream" calculations impossible.

Data are available separately for agriculture, forestry, and fishing; mining; construction; manufacturing; transportation; communication; electric, gas, and sanitation services; wholesale trade; retail trade; finance; insurance; real estate; services; and a residual where the nature of the business could not be allocated. In most of our tables, only the largest four groups are distinguished. These four are mining, finance, real estate, and services. The total is also provided.

Raw partnership data are available for five size classes, broken down by number of partners. The smallest class covers 2 - 50 partners. The next classes are for 51-100 partners, 101-500 partners, 501-1000 partners, and 1001 partners or more. Our presentation of the tables combines the middle three classes, making balance sheets and income statements available for small partnerships (2-50 partners), large partnerships (more than 1000 partners), and all other (51-1000 partners).

Recreation of Excised Data

A hypothetical example of the problems faced as a consequence of excised data is provided here. This is only an example, in order to reduce the size sufficiently to include it in text, but reproduces all of the important characteristics of the actual data. Consider a three industry breakdown, with industries labelled A, B, and C. Suppose there are also three size groups, numbered 1, 2, and 3. A typical selection of raw data with excisions (for example, total assets) would then be as shown in the following table:

Hypothetical Partnership Data

	A	B	C	Total
Size 1	100	*	*	470
Size 2	50	*	*	80
Size 3	10	20	30	60
Total	160	400	50	610

The entries marked with an asterisk are excised. If there is only one omitted observation in a given row or in a given column, then it is obviously possible to derive the result by subtraction. This applies occasionally to the IRS limited partnership data, but not very often. More frequent is the case shown above where it is not possible to deduce total assets of industries B or C for size groups 1 or 2.

On the other hand, we do know that the missing numbers must satisfy the following pattern:

Hypothetical Missing Data Only

	B	C	Total
Size 1	*	*	370
Size 2	*	*	30
Total	380	20	400

In this table, the data for industry A and for size group 3 (both of which are known) were removed from the matrix and from the marginal totals. What remains is a two by two matrix where only the marginal row and column totals are known.

The key to the next step is to recognize that the enormous differences in the marginal totals make it abundantly clear that most of the \$400 in missing assets can be attributed to industry B and size group 1. Very few (certainly no more than \$20) can possibly belong to industry C, for either size group, and little (no more than \$30) can possibly belong to size group 2, for either industry.

Our estimates allocate missing data in proportion to the marginal totals. In the above case, since industry A accounts for 380/400 (or 95%) of the missing column assets, 95% of the \$370 in missing assets (or \$351.5) in the first row are attributed to industry A and 5% (or \$18.5) to industry B. Correspondingly, 95% of the \$30 in missing assets (or \$28.5) in the second row are attributed to industry A and 5% (or \$1.5) to industry B. This produces the recreated matrix as follows.

Recreated Partnership Data

	A	B	C	Total
Size 1	100	351.5	18.5	470
Size 2	50	28.5	1.5	80
Size 3	10	20	30	60
Total	160	400	50	610

In this particularly simple case, the column sums add up afterward (ie, $\$351.5 + \$28.5 + \$20 = \$400$). When there are more than two missing elements in each row or column, then we are not finished because the column sums will not add up to the known column total. At this point, a common method of estimating the interior of a matrix, based on known totals, called the matrix balancing procedure or RAS method, is employed. This iterates successively from an adjustment to the columns, then the rows, then the columns again, etc. Gradually, the interior estimates will converge to the values that become our final estimates.

As noted above, this method produces reliable estimates for the "big" missing numbers, mainly because the very different row and column sums essentially provide tight boundaries on what the interior values can possibly be. On the basis of percentage estimation

error, however, the "small" recreated numbers may not be as reliable, but these are not very important to our conclusions. The reliable "large" recreated numbers are those that are important for our further analysis.

It is worthwhile pointing out that even the raw data are estimates. These are derived from samples, rather than from an exhaustive tabulation, by the IRS.

Analytical Transformations

The balance sheets included in our study are comparable with those in the IRS tapes (after recreation of excised data), but these were constructed in a somewhat more analytically usable form. Similarly, the income statements we provide were restructured for better analytical insights.

Finally, based on the data for 1983 to 1985 (or, as appropriate, for end-1983 to end-1985), we have

developed a sources and uses of funds presentation for each industry-size combination. These are available only for 1984 and 1985 since beginning and ending period data are required for each year that sources and uses of funds are to be computed.

Estimates of expenditures on capital investment were derived by adding estimates of retirements to the change in gross fixed asset accounts. Retirements, in turn, were based on detailed industry ratios of retirements to depreciation and depletion calculated by the Department of Commerce for partnerships and proprietorships. These ratios were then applied to the depreciation and depletion accounts reported by the IRS for limited partnerships only to obtain estimated retirements.

The definitions applying to the raw data and those applying to our transformations are spelled out in Appendix B.

APPENDIX B: DEFINITIONS

This appendix contains brief descriptions of the terms appearing in this report. The instructions that accompany the tax forms in Section 11 will provide additional information about many items.

Bad Debts

Bad debts occurring during the year, or reasonable amounts added to a reserve for bad debts, were allowable as deductions under section 166 of the Code.

Recoveries of bad debts previously deducted by taxpayers who used the reserve method were netted against the current year's bad debt deduction; recoveries by taxpayers deducting actual bad debts were included in "Other Receipts" of partnerships.

Business Receipts

Business receipts were, in general, gross receipts from sales and operations reduced by the cost of returned goods and allowances. They may have included excise and sales taxes that were included in the sales price of the product. Some taxpayers reported receipts this way and deducted the taxes as expenses, while others reported their receipts after adjustment for any taxes.

Generally, business receipts were income from the partnership's principal business activities. However, there were several exceptions to this rule. First, for partnerships in the finance industries, business receipts included such banking items as fees, commissions, trust department earnings, exchange collections, discounts, and service charges. Second, rents earned in addition to the company's principal income, and interest, royalties, and nonqualifying dividends, were for the most part reported separately. However, when rent was actual operating income (i.e., hotels, real estate operators, and manufacturers who rented rather than sold their products), the rental income was often reported in business receipts. In addition, if

gross rental income was the largest amount of income, this amount was transferred to business receipts during statistical processing. Finally, incidental income, such as cash discounts or recoveries of taxes or bad debts previously deducted, was usually shown as "other receipts."

Capital Gains and Losses

Capital gains and losses resulted from the sale or exchange of capital assets, which, for partnerships, were generally defined in the tax code to include any assets of the partnership not used in the normal course of business. Thus, property specifically excluded from treatment as capital assets was that held primarily for sale to customers in the ordinary course of business; depreciable business property, such as machinery; real estate used in the partnership's trade or business; and accounts or notes receivable acquired in the normal course of business. The net gain or loss realized by the partnership was reported separately from the gain or loss from normal business activities and was included in the income of the partners rather than in partnerships net income.

Cost of Sales and Operations

If the receipts of the partnership included income from the sale of goods made or bought, cost of goods sold generally included the direct cost of those goods. Therefore, cost of sales and operations included goods purchased for resale (in trade industries), and raw materials, supplies, labor, and other direct costs in agriculture, mining, manufacturing, and other industries that produced goods. "Cost of operations" applied to returns for which inventories were not an income-determining factor. Cost of operations generally included labor costs, supplies, rental of machinery and equipment, and other direct costs of producing services.

Current Liabilities

Current liabilities included certain amounts due and payable within the coming year. The account comprised accounts payable, mortgages, notes and bonds payable within one year, accrued expenses, as well as current payables not arising from the purchase of goods and services and not evidenced by bonds, notes, or mortgages. Examples of other current liabilities were taxes accrued or payable; accrued employee accounts, such as those for payrolls and contributions to benefit plans; overdrafts; and accrued interest or rent.

For partnerships in the construction industry, amounts of advances or deposits on uncompleted contracts and jobs in progress were included in this item, if reported as current.

Depletion

Depletion, a deduction allowed for the exhaustion of natural deposits or timber, was either based on cost, or, for natural deposits, on a fixed percentage of gross income, less rents and royalties paid, from the depletable property. Generally, the gross income for gas and oil wells was the actual sales price, or representative market or field price if the gas or oil was converted or manufactured prior to sale.

Depreciation

The deduction for depreciation permitted a reasonable allowance for the exhaustion, wear and tear, and obsolescence of business property in cases where the estimated useful life of the property exceeded one year.

Employee Benefit Plans

These were contributions made by employers to employee benefit plans other than deferred-compensation plans, which were deductible under Code sec-

tion 162. These plans included hospitalization, health and accident insurance, group life insurance, group legal services, and other employee welfare plans.

Income (or loss) from Other Partnerships and Fiduciaries

This item was the partnership's share of ordinary income (loss) of another partnership. If a partnership reported a loss from another partnership, the amount of the loss that it could claim was limited either to the investment that the partnership had that was "at risk" or to the amount of the adjusted basis of the partnership's interest in the other partner.

Intangible Assets

Net intangible assets were the total gross amounts (after the reduction by amounts of accumulated amortization) for contracts, copyrights, formulas, licenses, patents, registered trademarks, research or experimental expenditures, and similar assets.

Interest Paid

Interest paid in connection with business indebtedness was deductible as a business expense. Included in the statistics was interest paid on deposits and withdrawable shares by banking and savings institutions. Also included were amounts paid by partnerships to a partner, acting in the capacity of lender to the partnership rather than as a partner.

Included in the statistics were amounts of interest paid on installment purchases if they were stated in the contract, as well as unstated amounts of interest as provided in Code section 483.

Not included were amounts of interest on funds used to purchase property held for investment, which were allocated directly to partners. This separate reporting was due to the limitation on investment interest ex-

12

pense imposed on the partners rather than the partnership.

Interest Received

This item included interest received by the partnership from all sources, except wholly tax-exempt interest and interest on tax-free covenant bonds. Included in this item were amounts received on loans, notes, mortgages, bonds, bank deposits, and corporate bonds less amortization bond premiums.

Inventories

Inventories consisted of goods held for sale and raw materials and supplies that became a part of goods held for sale.

Investments

Investments included mortgage and real estate loans, long-term non-Government investments and certain investments for which no distinction could be made as to their current or long-term nature. Non-Government investments included stocks, bonds, loans on notes or bonds, and other types of financial securities.

Mortgage and real estate loans were, in general, the total amount that a partnership loaned on a long-term basis for which the partnership accepted mortgages, deeds of trust, land contracts, or other liens on real estate as security.

Land

Land that was reported as a separate capital asset on the balance sheet may be understated in this report, because it could not always be identified. Some partnerships may have included land as part of "Buildings and Other Depreciable Assets," "Depletable Assets" or included it in "Other Investments."

Limited Partnerships/Partners

A limited partnership, identified by the response to a question on the Form 1065, is a partnership composed of at least one general partner (i.e., one who is personally liable for the obligations of the partnership) and one or more limited partners. A limited partner is one whose potential personal liability for the partnership's debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership.

Liquid Assets

This balance sheet asset item included the amount of actual money, instruments, and claims that were usable and acceptable as money.

This balance sheet asset item consisted of (1) U.S. obligations including those of instrumentalities of the Federal Government and (2) bonds or other obligations of a State, or U.S. possession, including obligations of political subdivisions and of the District of Columbia. In those instances where a partnership reported only one total for investments in Government obligations and did not indicate whether the obligations represented those of the United States or of State or local Governments, the total was treated as investments in U.S. obligations.

Long-term Debt

Mortgages, notes and bonds payable reported on the balance sheet with a maturity of more than one year.

Net Depletable Assets

In general, net depletable assets represented the gross value of mineral property, oil and gas wells, other natural deposits, standing timber, intangible development and drilling cost capitalized, and leases and

leaseholds subject to depletion less accumulated depletion.

Net Depreciable Assets

Net depreciable assets, reported on the partnership's end-of-year balance sheet, consisted of tangible property (such as buildings and equipment) that had a useful life of 1 year or more and was used in the trade or business, or held for the production of income.

The amounts are shown for after adjustments for depreciation or amortization charges in current and prior years.

The value of depreciable assets and accumulated depreciation may not be closely related to the current year depreciation deduction. The depreciable assets and accumulated depreciation balance sheet accounts reflected book values; the depreciation deduction reflected the amount claimed for tax purposes.

Net Gain (or Loss), Noncapital Assets

This item represented gains and losses from the sale or exchange of property not eligible for beneficial capital gains tax treatment by partners. Such gains and losses resulted mostly from the sale or exchange of trade or business property. Also included were the involuntary conversions of trade or business property and of certain capital assets.

Net Income (or Deficit)

Net income or deficit represented the difference between total income (loss) and total deductions.

Net Sales of Property

Net sales of property reflects the excess of retirements and property disposals over the accumulated depreciation and depletion for these accounts. It is calculated from: capital investment less depreciation and depletion minus the change in net property accounts. The estimation of capital investment is discussed in Appendix A.

Nonqualifying Dividends Received

Nonqualifying dividends were corporate dividends that were received by the partnership for which the individual partners were not entitled to an exclusion on their individual income tax returns when the income was passed through to them. Nonqualifying dividends were paid by corporations exempt from tax (generally charitable organizations and farmer's cooperatives), regulated investment companies, certain real estate investment trusts, and foreign corporations. Partnerships were instructed to report "dividends" paid on deposits in banks and savings institutions as interest received and not as dividends.

Nonrecourse Loans

Nonrecourse loans were loans obtained by the partnership for which none of the partners had a personal liability. Generally, these were loans for which the real property of the partnership served as collateral.

Other Assets

Other assets comprised, in general, noncurrent assets that were not allocable to a specific account on the return form balance sheet, and certain accounts for which no distinction could be made between current and noncurrent status. Includable were such items as deferred charges reported as noncurrent by the

partnership, interest discounts, guaranty deposits, and intangible assets not subject to amortizations.

Other Current Assets

Assets not allocable to a specific current account in the return form balance sheet, assets specifically reported as short-term by the partnership, and marketable securities other than Government obligations comprised this account.

Included were accounts receivable, prepaid expenses, nontrade receivables, coupons and dividends receivable, claims and judgments, and similar items. For partnerships in the construction industry, amounts reported as a current item for contract work in progress in excess of billings were included in this item.

Other Deductions

Other deductions comprised business expenses that were not allocable to a specific deduction item on the return form, such as: administrative, general, and selling expenses; bonuses; delivery, freight, and shipping expenses; truck and automobile expenses (except repairs); utilities; supplies; advertising and promotion; travel and entertainment; dues and subscriptions; postage and stationery; sales discounts; and laundry, uniforms, and cleaning. The item also included unrealized profit on current-year installment sales; reported amounts of negative income; commissions; insurance; and legal and professional fees.

Other Liabilities

Other liabilities were obligations that were not allocable to a specific account on the return form balance sheet and that were either noncurrent accounts, in general not due within 1 year, or accounts that could not be identified as either current or long-term.

Examples of other liabilities were deferred or unearned income not reported as a part of a current account, and principal amounts of employee and similar funds.

Other Receipts

This item included amounts not elsewhere reported in the income statement, such as: income from minor operations; cash discounts; income from claims, license rights, and judgments; net amount earned under operating agreements; profit from commissaries; profit on prior years' collections (installment basis); recoveries of losses and bad debts previously claimed for tax purposes; refunds for cancellation of contracts; and income from sales of scrap, salvage, or waste; and income from annuities and insurance.

Partners Capital Accounts

The balance sheet item for partners' capital accounts was the partners' total equity in the business as of the end of the taxable year. It was the net sum of all contributions of capital by the partners, plus the partnership's accumulated earnings, less accumulated losses and any distributions of capital and earnings.

Payments to Partners

Guaranteed payments that were made to partners for services rendered or for the use of capital, if such payments were determined without regard to income of the partnership, were allowed as a deduction to the partnership. The payments were taxable to the partner who received them.

Profit Margin from Operations

Net income less income from fiduciaries, other partnerships, nonqualifying dividends and interest,

rental, royalty and farm net income and net gain from noncapital assets as a ratio to the sum of "business" and "other" receipts.

Rent Paid

Rent paid on business property was deductible as a business expense. Identifiable amounts of taxes and other expenses paid by leasees in connection with rent paid were included in their respective deduction headings.

Rents Received

If rents were the largest income item, they were included in "Business Receipts."

Repairs

This deduction included the costs of labor and supplies and other costs necessary for incidental repairs to the property.

Retirement Plans

This deduction was the employer's contribution to employee pension, profit-sharing, annuity, bond purchase, and other deferred compensation plans that were deductible under Code section 404.

Royalties

This income item consisted of the gross amount of royalties received, generally on an agreed percentage basis, for the use of property rights, including patents, copyrights, timber, minerals, or oil wells. Expenses relating to this income, such as depletion and taxes, were included in their respective deduction categories.

Salaries and Wages

This item consisted of those salaries and wages not included as "cost of labor" in the cost of sales and operations schedule and not included in some other deduction category on the return. Salaries to partners were not included in this item, but in "Payments to Partners."

Taxes Paid

Taxes paid included the amounts reported as a business deduction. Included among the deductible taxes were ordinary state and local taxes paid or accrued during the year; social security and payroll taxes; unemployment insurance taxes; import and tariff duties; and business, license, and privilege taxes.

Income and profits taxes paid by the partnership to foreign countries or U.S. possessions were allocated to the partners for use as a deduction or a credit against income tax. Federal income taxes, gift taxes, and taxes assessed against local benefits were not deductible.

Mr. DAVIS. Certainly master limited partnerships are an important subject for your interest and oversight, having become much more common since their introduction in late 1980. MLP's are a convenient and efficient entity for holding income-producing assets.

Unlike the ordinary limited partnership, MLP's permit people to buy or sell on an established security exchange. That liquidity is important in attracting equity capital, seeking currently distributed income taxable only once at the partner level.

We believe it is reasonable to suggest that MLP income, although taxed only once at the partner level, may be taxed at about the same amount as income earned through a conventional corporation. That income is subsequently distributed as a dividend to shareholders under the two-tier system that taxes income earned at the corporate level, and then taxes the same income again at the shareholder level when dividends are received.

Corporations have increasingly been leveraging their investments through debt financing, which may make their long-term financial position more precarious. Such borrowings reduce corporate tax payments through use of the interest deduction. Further, tax exempt entities, such as pension funds, endowments, or qualified foreign investors, may receive a substantial share of corporate interest payments. This suggests to us that MLP's may, in fact, generate taxable income to the same extent our two-tier tax system now does.

As you review the tax treatment of MLP's, and partnerships generally, we urge you to carefully review existing law, and the subchapter C study to be transmitted to Congress by the Treasury Department before the end of this year, before taking any final action.

We also hope you will carefully review the case studies contained in our written testimony which summarize the very real activities you may affect by any changes you may choose to recommend to the full Ways and Means Committee.

Partnerships, as you know, have a special place in American economic history; indeed, are part of our national character. The first textile mills in America, for example, were made possible by two men risking their capital in a partnership the year our Constitution was adopted. Success was far from certain. Partnerships then, as now, were for risktakers, not coupon clippers.

Today independent oil companies, for example, get most of their funds from limited partnerships. In 1985, 48.5 percent of the expenditures on U.S. oil exploration and development, producing 35 percent of the crude oil produced that year, was financed through limited partnerships. Certainly housing needs partnerships.

Mr. Chairman, I am certain you know of the development on 126th Street in the East Harlem Triangle Urban Renewal Area where 255 units of low-income housing resulted from a limited partnership. Over 10,000 families, by the way, applied to live there when the building opened in 1981. We ought to do nothing to hinder the unfinished business there, and elsewhere within our central cities. Those apartments not only provide a positive environment, they provide hope. They provide not just urban renewal, but human renewal. Corporations would not touch such a project,

and government sponsorship of similar units has not brought equal success. Partnerships made that project possible.

Partnerships today also finance research and development that will affect this Nation for decades—maybe centuries—ahead. One company, one company alone, has produced a medicine that permits growth-deficient children to obtain a physical stature and development normal for their age, a blood clot dissolving agent with great promise for heart attack patients, an immune system protein that is believed to stimulate the body's natural defenses against viral and cancer cell activity, and an agent with the potential for destroying cancer cells without measurably affecting healthy cells. Partnerships made all of that possible, because no other economic device was available in this affluent corporate society for such risky projects.

Partnerships are creative and innovative and entrepreneurial when go slow, don't rock the boat, noncompetitive impulses are dominant. No one ever left a partnership with a golden parachute worth millions and millions of dollars. Some left poorer, some left richer. What they all had in common was a willingness to take a chance.

I hope the committee and its staff will review the case studies in our written testimony.

Tax policy, obviously, has consequences in the real world. The tax policy you are reviewing has permitted partnerships to finance housing for Americans of all incomes, biomedical research and development which may help cure diseases like cancer and AIDS, energy exploration that may one day lead to American energy independence, and a host of other valuable activities.

Finally, let me urge the committee to resist retroactive changes which may balance the books, but which leave unbalanced the American concept of justice and fair play. Contracts and agreements entered into in good faith, like rules of the game, Mr. Chairman, should not be retroactively changed.

The Investment Partnership Association wants to be helpful in supporting sound tax policy. We believe good tax policy also means solid social results.

Thank you.

[The prepared statement of Mr. Davis follows:]

TESTIMONY OF MR. CHRISTOPHER L. DAVIS
 PRESIDENT OF THE INVESTMENT PARTNERSHIP ASSOCIATION
 SUBMITTED TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
 HEARING ON THE ISSUE OF MASTER LIMITED PARTNERSHIPS
 TUESDAY, JUNE 30, 1987

My name is Christopher L. Davis. I am the President of the Investment Partnership Association (IPA). The IPA is the national organization of partnership investors and sponsors. Most sponsors of public partnership programs being offered to investors today are members of the IPA. Our members include, for example, Integrated Resources Inc., JMB Realty Corporation, Southmark Capital Corporation, E.F. Hutton & Company, Inc., Merrill Lynch, Hubbard, Inc., Angeles Corporation, VMS Realty Partners, Public Storage, Inc., and Silver Screen Management together with many of the major law firms, accounting firms and other businesses serving this industry.

The IPA serves as the primary spokesman for the partnership industry and through our members and consultants, provides technical support to both industry and government.

My testimony today will highlight the role of partnerships in attracting investment capital and in creating equity participation by both large and small investors. I will review the need for exercising care in considering legislative changes affecting both traditional partnerships and master limited partnerships. Most importantly, the Investment Partnership Association strongly urges that existing investments not be subjected to retroactive changes that significantly alter the economic rationale for such investments. Last, but by no means of least importance, I am here today to express the Association's strong commitment to working with the Committee in developing solutions to any technical and compliance problems that may exist in the case of master limited partnerships.

EVOLUTION OF MLPs AND THEIR ROLE

In late 1980, the first master limited partnership (MLP) was publicly offered by Apache Petroleum Company. MLPs grew slowly through 1985 and consisted mainly of oil and gas programs, a few real estate partnerships and a few timber programs. One of the unique features of an MLP is that, unlike the ordinary limited partnership, it provides its partners with the ability to purchase or sell partnership interest on an established securities exchange. MLPs are thus a convenient and effective entity for holding income producing assets readily valued in the market place. MLPs have become attractive to investors wishing to make equity investments which produce current distributions of income. Accordingly, income producing assets can be placed in an MLP and offered to the public at their full fair market value.

MLP holders obtain the right to receive a relatively high yield on their investment as well as the ability to sell that interest for cash at any time. Conversely, the utility of MLPs is limited under the passive loss rules adopted in the 1986 Tax Reform Act, generally barring current deductions for passive losses. It is generally disadvantageous for MLPs to incur indebtedness since the payment of interest and repayment of principle will reduce the ability of the MLP to distribute income to partners. Moreover, partners may be precluded from currently deducting any losses (in part consisting of interest payments) incurred through an MLP.

The relative advantage of MLPs is the availability of a partnership investment that is liquid. This advantage inures to the benefit of each partnership holder and to our economy in

general. From an economic standpoint, MLPs are advantageous in that they attract equity capital from investors seeking income that is currently distributed. The income distributed is then taxed to individual partners.

On the other hand, under current law, those who invest in corporations may proceed in a very different way. To reduce the burden of our two-tier tax system that taxes income once when it is earned by a corporation and once again when it is distributed in the form of dividends to shareholders, the strategy described below may be followed. A corporation may borrow substantial amounts of money to finance its operations. By borrowing funds as opposed to securing additional equity investment, the corporation can enhance the net return on existing equity and treat the payment of interest on borrowed funds as a deductible expense as opposed to a non-deductible dividend payment for additional equity investment.

Consequently, corporations have increasingly been leveraging their investments through debt financing which may make their long term financial position more precarious. Corporate borrowing has resulted in reduced corporate tax payments through the allowance of the deduction for interest paid on such debt. Often the payment of interest is to tax exempt entities such as pension funds, endowments or qualified foreign investors. It is therefore not unreasonable to question whether any significant change in Federal income tax receipts would occur in the event the pass-through tax status of MLPs were to be changed. We are convinced that as a practical matter, although only taxed once at the partner level, MLP income may be subject to roughly the same amount of tax as income earned through a conventional corporation and subsequently distributed to its shareholders under the present two-tier tax system.

The IPA therefore urges that no changes in the basic pass-through tax status of MLPs be made at this time. Under the Tax Reform Act of 1986, the Treasury Department has been directed to review the entire structure of Subchapter C and to submit its findings and recommendations to the Congress by the end of 1987. Until that comprehensive review of Subchapter C and its relationship to the various pass-through entities under the Code is completed, we believe any change runs the risk of being at odds with the overall conceptual framework of the general rules for taxing business and investment income that may be formulated and approved within the next twelve to eighteen months.

We believe sound tax policy requires patient and thoughtful review. Hasty action in the context of a Reconciliation effort by the Congressional tax writing committees on a matter that is so basic to our tax system would be very imprudent in our judgment.

THE IMPORTANT ROLE OF PARTNERSHIPS IN ATTRACTING CAPITAL

As a form of business organization, the partnership has always appealed to Americans seeking to form new ventures. It is intensely entrepreneurial and accommodates the self-reliant, do-it-yourself spirit of individuals. Identify an economic need and the partnership provides an immediate business structure to cultivate the opportunity. At the same time, the partnership satisfies the American sense of community, joining together for the common good.

The partnership is uniquely designed to unite talent and resources productively and efficiently. Less cumbersome than a corporation, the American partnership has been able to accumulate funds quickly to start up an enterprise at the optimal moment. At the same time, its simple, direct structure has allowed the entrepreneur managerial control over all phases of his operation, resulting in knowledgeable integration of activities. And it has proven itself adaptable to almost any business venture, undertaking crucial projects inappropriate for other kinds of organizations.

Partnerships fall into 3 categories -- general and limited partnerships and master limited partnerships. General

partnerships, as the name implies, are entities within which each partner has a general right to share in both profits and losses of the partnership. These rights are unlimited and each general partner may be called upon to satisfy the full amount of any partnership indebtedness or other obligation to outside parties. Within the partnership, the general partners will usually be obligated to one another to the extent of their economic interests. For example, a general partner with a 10% partnership interest may be entitled to 10% of all profits and may be liable for up to 10% of all partnership losses. If such a partner is called upon by outside parties to satisfy a partnership obligation greater than his 10% share of the obligation, this partner will generally have a right to seek contributions from other general partners to the extent of their partnership interests.

A limited partnerships' economic arrangement is structured so that it is composed customarily of one general partner (required to meet a substantial net worth requirement by the IRS) and any number of additional limited partners whose liabilities are limited under the partnership agreement to a fixed amount (generally, not in excess of their fixed investment in the partnership) and such limited partners participate in the income and losses of the partnership as provided under the partnership agreement. In the most basic limited partnership arrangement, limited partners will contribute in excess of 95% of the capital utilized by the partnership and in exchange will be allocated, in the aggregate, an identical amount of income and loss from the partnership. This type of entity has been utilized broadly as a means of raising large amounts of capital for investment in real estate, oil and gas, entertainment, equipment leasing, and similar enterprises. This type of partnership can be used for small private offerings of less than 25 investors and can also be registered with the Securities and Exchange Commission and offered to thousands of individual investors through registered securities representatives. Such partnership interests, once purchased, are generally held for a long period of time so that the partnership can realize maximum income or gain from the underlying investment. Individual limited partners are generally unable to transfer these partnership interests except where the general partner has made special arrangements to assist in securing other investors to permit a limited partner to transfer his or her interest. This is frequently done to accommodate limited partners who encounter economic hardship.

For the Committee's information, The Investment Partnership Association presents a few brief case studies detailing the important contributions of several successful partnerships.

I strongly urge the Committee and its staff to review these case studies. All too often we separate technical considerations of tax policy from practical application. The tax policy considerations your Committee will review are integrally related to adequate funding for affordable single family and multi-family housing for all Americans, biomedical research and development, energy exploration and development and other socially and economically desirable undertakings. The following case studies are offered to illustrate the success of four partnerships in meeting important needs.

PARKER & PARSLEY PETROLEUM PARTNERSHIPS

The United States currently imports 41 percent of the crude oil and refined product it consumes. The situation leaves us in a vulnerable position unless energy conservation and domestic production are to be increased.

Oil and gas exploration and development are among the riskiest of business ventures. Fortunately, partnerships have proven to be an economical way to share the risks. One of the most successful of the independent oil companies, Parker & Parsley Petroleum of Midland, Texas, has relied upon partnership investment to adopt advanced, specialized, and in some cases unique techniques of prospecting, evaluating, drilling,

completing, and operating oil and gas properties. From 1981 through 1987, Parker & Parsley engaged in 16 limited partnerships to finance its developmental drilling activities in the proven Spraberry Field and in the Cherry Canyon Field. During that time 568 wells were drilled, 96 percent of which became commercially productive and are expected to produce for 25 to 35 years.

Most of the capital that funds independent oil companies actually comes from limited partnerships. In 1986 the independents accounted for 48.5 percent of the \$33 billion spent on oil exploration and development in the United States. The production that resulted contributed 35% of the nine million barrels per day of crude oil this country produced in that year, including the Alaskan North Slope. Such limited partnerships are a traditional business structure heavily utilized in energy development. The ability to successfully attract capital through partnerships engaged in the production of oil and gas must be continued. It is this ongoing investment that will promote continued competition in this industry and will augment our effort to increase our domestic oil and gas reserves.

1775 HOUSING ASSOCIATES

1775 Housing Associates is a real estate limited partnership formed to develop, construct, own, maintain, and operate a 255-unit 11-story brick-faced apartment building completed in 1981 and located on 126th Street in the East Harlem Triangle Urban Renewal Area of Manhattan. Over 10,000 families applied to live in this low-income housing project, which was built in conjunction with the program established by Section 8 of Title II of the Housing and Community Development Act of 1974. Two residents were interviewed on February 6, 1987 about their life at 1775.

Mrs. Wille May Livingston is a tenant of the housing project. "I always told everybody this building's a miracle to me. The place where we came from -- 115th and Lenox Avenue -- is a disaster area. When you dressed to come out with your kids to go to church, you walked over garbage, over people lying in the hall. And you heard everything that is unpleasant to the mind and the ears on your way. We weren't used to that. My kids wanted to know why all the people were sleeping on the street. They couldn't understand the crowd on the corners all day long. And the tragedy, seeing people abused in the street, abused on top of the roof. I had a baby, and on the sixth floor, it was so hot, he used to suffer from dehydration. And the doctor said he needed air. How could you air condition a seven-room, run-down tenement place, the windows were broken, the doors hanging off? Maybe hot water one month, and without for two months. The heat was the same way. The elevator had been out ever since we moved in.

"And then when you get a place like this, that's when you appreciate it. There's nothing that I wouldn't do to keep this building. The security is fantastic, from where we used to live -- you always had to get somebody you know to escort you in the building. But now you can ring up for your kids. When my mother-in-law comes here, she can go in the back yard and sit outside. She enjoys it. We have day care mothers in the building. That was a blessing too -- to be able to work and be home when my kids come home. The parents attend the PTA meetings much better -- to keep the school on the same standard that you are living on. If you were in the old neighborhood, you're scared to go. You meet other families in the building. They are glad about the building and are proud to be here. We tell the young people the value of these places. This will get to be your home later on."

Ms. Alice Kornegay, resident social worker: "We just all come in as a big family. So you have kids going to parochial school and public school and private school elsewhere who live right here. We have teachers in high school and college living here, able to make sure the young people follow in their footsteps. We have elderly and disabled. Most people are working.

"We thought that we wanted an urban renewal area. We wanted a human renewal area, to deal with the human side of people. That we don't take them from one rundown slum, and put them into another rundown slum. A lot of these people could have been homeless people today. I know what it is to look at vacant land, and nothing is happening. So you have to spend money.

"The partnership said, 'we're going to try and help people to help themselves.' All they did was invest the money to make sure the people could get a decent place to live and ask for a return on their investment. Instead of taking every penny from a project they put money back into the community."

During the ten years in which Section 8 development was authorized, 13,589 single or multi-building projects consisting of 841,870 rental units were scheduled to be either built or substantially rehabilitated across the country through this joint effort between the United States Government and private enterprise. By the beginning of 1987, 786,393 apartments were occupied by families who had finally found adequate housing and a measure of human dignity. The great majority of these projects were undertaken with partnership investment.

SILVER SCREEN PARTNERS

Since the 1970's, limited partnerships have played a significant role in providing funds for the production and distribution of motion pictures. A great variety of the finest and most popular films -- from Star Trek to Saturday Night Fever to The Big Chill -- have been brought to millions of Americans through partnership investments. While earlier movie partnerships were tax-advantaged in structure, more recent ones are geared primarily to generate income. Whatever the structure, these partnerships enable a wide range of investors to participate in an industry otherwise closed to them. These partnerships expand the opportunities for jobs in one of our most labor intense industries. These investors also make it possible to share the financial risks of bringing to the public an unpredictable but beloved entertainment product.

One of the most successful series of movie partnerships is the Silver Screen Partners. Since 1983, 85,239 investors have contributed \$576 million to finance Silver Screen motion pictures. Silver Screen's three offerings are the three largest film financing partnerships ever assembled. Silver Screen partnerships are designed to protect capital and provide income and appreciation. Capital is used exclusively to finance 100 percent of a film's production cost. Among the movies supported by Silver Screen partnerships are The Color of Money, Outrageous Fortune, Down and Out in Beverly Hills, Ruthless People, and Tin Men, as well as a number of Walt Disney Pictures films, both live action and animated, designed for family audiences. Silver Screen Partners has been able to provide many new jobs for the entertainment industry as well as many widely acclaimed films for the movie going public.

GENENTECH, INC.: BIOTECHNOLOGY

Harnessing genetic processes for man's benefit requires both the genius of microbiologists and the foresight of investors willing to undertake the risk inherent in pharmaceutical research. Founded in 1976, Genentech, Inc. has relied upon three limited partnerships to finance the research and development of four significant biotechnology products. For example, Protoprin is currently the only hope of children suffering from growth deficiency to attain a physical stature and development normal for their age.

Genentech's other biotechnology products whose research and development are being funded by limited partnerships are equally important. Activase (t-PA), a blood clot-dissolving agent for cardiovascular diseases, is undergoing its clinical

trials for treatment of heart attack. To date, nearly 4,000 heart attack patients have been treated worldwide, and for 70 to 80 percent of those patients, the clots causing the heart attack have been dissolved. Gamma Interferon, a protein of the immune system that is believed to stimulate the body's natural defenses, is presently undergoing clinical trials for anti-viral and anti-cancer activity. Tumor Necrosis Factor (TNF) shows potential for destroying cancer cells without measurably affecting healthy cells, thus providing a significant advantage over conventional chemotherapeutic agents.

Barely a decade old, the biotechnology industry consists of some three hundred companies that have developed about three dozen products that are radically transforming medical and agricultural horizons. For Genentech, the limited partnership supplies a business structure through which an adequate level of funding can be obtained while the large investment losses inevitable in the early stages of research and development can be absorbed. Biotechnology is another American revolution that partnership investment has helped nurture.

PROCEED WITH CAUTION ON FUTURE LEGISLATION

As a result of legislation previously enacted by Congress, partnerships are no longer used to develop transactions which would be classified as primarily tax motivated. Moreover, recent legislative changes have dramatically circumscribed taxpayers' ability to shelter income through partnership investments.

Most, if not all, of the potentially abusive applications of partnerships were dealt with by Congress (and by Treasury in subsequent regulation) in earlier tax legislation. For example, in the Deficit Reduction Act of 1984 (the "1984 Act") Congress adopted stringent allocation rules in order to prevent artificial shifting of tax benefits between partners with respect to pre-contribution gain or loss. More recently, Treasury has furthered Congress's intent by promulgating comprehensive regulations to ensure that partnership allocations have substantial economic effect aside from their intended tax effect. As a result, taxpayers can no longer use partnerships to shift income and deductions in a manner at variance with economic reality.

Another legislative change preventing abusive use of partnership is the expansion of the original issue discount rules for deferred-payment transactions involving property. Taxpayers can no longer artificially inflate the purchase price of property and thereby convert interest into loan principal. (Although this abuse was not limited exclusively to partnership transactions, its use was frequently associated with them.)

TAX ORIENTED INVESTMENTS SIGNIFICANTLY REDUCED UNDER THE TAX REFORM ACT OF 1986

The non-abusive use of partnerships as vehicles for sheltering unrelated income of investors has been effectively eliminated under the Tax Reform Act of 1986 (the "1986 Act"). The leading tool of the 1986 Act is the passive loss limitation rules. These rules treat a limited partnership interest in a trade or business as conclusively passive. As a result of these provisions, partnership losses can no longer be used by partners to offset unrelated positive income. Moreover, additional tightening was achieved through amendments to the investment interest rules. Under the 1986 Act, investment interest in excess of income generated by passive investments cannot be used to offset income from active sources. Thus, the new rules limit the deductibility of investment interest to the extent income is generated from the investments with respect to which the indebtedness was incurred.

The focus of the 1986 Act passive loss rules was on the elimination of investments structured to generate losses for non-

participating investors that could be used to offset other positive sources of income. While there is concern about the long term ramifications of the 1986 Act changes on certain investment such as low income housing where rates of return are not sufficient to attract capital, all concur that these changes have addressed the "sheltering" concern so often voiced about partnership losses.

In addition to these limitations on the use of partnerships, Congress' repeal of the General Utilities doctrine provides an additional constraint on the use of partnerships as a means of avoiding imposition of the corporate level tax. Although the 1986 Act's lower maximum individual tax rate (which is lower than the corporate rate) caused initial concern that it would stimulate entity conversions from corporate to partnership form, with the repeal of General Utilities, such conversions are in most cases not economically feasible because the tax now would be imposed at the corporate level upon liquidation.

FURTHER CHANGES MUST RESPECT EXISTING INVESTMENTS

In many instances, the 1986 Act imposed retroactive changes on the treatment of various investments. For example, investments in limited partnerships made prior to the date of enactment were subject to the new passive loss rules, even though at the time those investments were entered into, the existing law provided for different tax treatment. The effect of these retroactive changes is to alter the rules in the middle of the game and thereby effectively deny the benefits anticipated at the time such investments were entered into. This retroactive legislation has badly shaken investor confidence. Moreover, the imposition of tax on transactions entered into in reliance on prior law, where the law has been retroactively changed, raises serious constitutional questions that have not yet been fully addressed.

After the retroactive changes made in the 1986 Act, we would hope Congress would eschew additional retroactive changes to the rules governing treatment of master limited partnership investments. Specifically, taxpayers who have entered into such arrangements in reliance on the treatment of partnerships as pass-through entities should not be severely disadvantaged by a subsequent denial of such status.

In addition to problems with investor uncertainty which have resulted from the retroactive application of several provisions in the 1986 Act, there remain many unanswered questions which have led to problems in restoring investor confidence. While some of these uncertainties are typical of investor reaction to any change in the tax laws, others appear unique. I would like in particular to focus on a provision contained in the passive loss rules, section 469(k)(3), which delegates an unprecedented broad grant of regulatory authority to the Treasury to recharacterize passive income as portfolio income. With this authority the Treasury is permitted to ignore the statutory classification of income made by Congress whenever the Treasury determines that such classifications are not appropriate.

The existence of this authority has generated ongoing investor uncertainty. Unlike other regulatory issues that may be resolved when the passive loss regulations are eventually issued, this grant of authority can be exercised by the Treasury at any time and under virtually any circumstances. Its existence is particularly unsettling in light of the authority contained in section 7805(b) allowing the Treasury to issue such regulation retroactively.

We would strongly recommend that this grant of authority to the Treasury be removed. Its existence makes it virtually impossible to fully apprise investors of the tax treatment of any investment involving a limited partnership.

Finally, we wish to reiterate our strong concern that any tax changes regarding pass-through entities be part of a comprehensive review of these entities and their relationship with the rules of Subchapter C. Changes should not be made in isolation, just to "get some money."

Thank you.

Chairman RANGEL. Thank you, Mr. Davis. You make somebody thinking about changing the partnership laws look like a Communist. [Laughter.]

Mr. DAVIS. Not a Communist, Mr. Chairman, just un-American. Chairman RANGEL. Mr. Stanger?

STATEMENT OF ROBERT A. STANGER, CHAIRMAN, ROBERT A. STANGER & CO.

Mr. STANGER. Thank you, Mr. Chairman. I am Robert A. Stanger. I'm here representing my own company. We maintain a certain amount of data about the partnership investment business, and I came to share some of that with you.

I gather from some of the earlier comments that there are some basic questions. One is: how big is big? And the other is: what are the revenue gains available here? Let me see if I can address those issues for you.

The 99 issues of MLP's that were alluded to in the Wall Street Journal—the figure did come from us. The difference between our figure and the Secretary's figure is the number of MLP's in registration.

Our definition of public market is National Stock Exchange, or NASDAQ. Those 99 issues represent \$31.5 billion of equity, of which, however, only \$12.5 billion is in the hands of the public.

To describe the size of the market, that \$12.5 billion grew \$2.4 billion in 1986, from \$10.1 to \$12.5. The largest quarter of issuance was the fourth quarter of 1986 approximately \$1.4 billion in anticipation of *General Utilities*. The quarterly figure has not been exceeded since. The first quarter of this year was down from that number, and most assuredly so will be the second quarter.

Our estimate is, nevertheless, that \$3.7 billion of equity in MLP's will be raised in 1987. To put that in the "how big is big" category, in the month of May the nonmoney market mutual fund industry raised \$13.83 billion. That, indeed, was a bad month, down from \$25 billion the preceding month.

There was a question about what were euphemistically described as "junk bonds" before. I do happen to know the amount of newly issued corporate nonrated debt in 1986. It was \$48 billion.

So if you put what's happening in the MLP industry in the juxtaposition to other financial instruments it is, indeed, quite small.

Let me talk to the revenue gain issue. First, may I point out that we are not revenue estimators. We are financial analysts; and, therefore, with total humility I'd say we are representing the facts. What the revenue estimators are representing, I do not, indeed, know.

Let me inform the committee that first and foremost, 60 percent of MLP equity is owned by the corporate sponsor of the MLP, and hence any distributions or income from those partnership interests is already subject to double tax or corporate taxation.

Of the 40 percent that is owned by the public, the distributions will be approximately \$1.1 billion for 1987, of which only \$239 million, or 21 percent, will be taxable. This comes from an analysis of the financial statements of all 99 publicly traded MLP's on the market today.

Using 1988 tax rates, the net revenue gain, if you tax that income at the corporate level and then pay it out again and tax it fully at the individual rate, would be \$58 million to the Federal Government.

That assumption is our optimistic assumption for three important reasons: one, 74 percent of all MLP's are heavily asset oriented in the real estate and oil and gas business, and they can probably be converted to REIT's or royalty trusts; and, more importantly, 40 percent of the total taxable income in the MLP industry is from partnerships that own mortgages, and they have many alternative forms—REMIC or REIT's.

So, if there were an attempt to tax MLP's there are many avenues where tax revenues would not be generated, or be considerably less than the \$58 million that I cited.

Let me make some brief comments on the Joint Committee's possible proposals on the taxation of MLP's. Let me lump taxing MLP's and applying the corporate AMT to MLP's and LP's, which were suggestions one and three in the Joint Committee's proposal. I believe the Treasury's estimate of revenue gain is highly inaccurate. I will also note that the larger the revenue gain, the farther out the estimate is, and hence the less certain. The estimate for 1988 is only \$24 million.

I think a grandfather rule, which was proposed in the Joint Committee's transmittal, is important. In the first place I think not grandfathering will drive these entities into some other form of business organization, anyway, and I think if you do not grandfather, politically at least you'll double the opposition to any changes that you would suggest.

Extending the concept of corporate taxation to all publicly registered partnerships, I think, is a serious mistake. Nontraded partnerships are not operating corporations and don't fall under any of the fears that were articulated by Mr. Mentz concerning disincorporation. They are asset holders, and as such they have easy conversion options.

I would also like to point out here that our estimate is, in the nontraded partnership industry, there is approximately \$200 billion of assets. At the same time there is only about \$16 billion of assets in the REIT industry. So it is very clear what is the vehicle of choice in the capital markets for entities of this sort, and it is the partnership, and it is not the REIT.

The MLP industry delivers k-1's annually to all limited partners in which all limited partnership income, all income of the MLP, is allocated to a limited partner. It may not be allocated to the right limited partner, but there is no revenue loss net to the system.

I'm sure the industry would cooperate in any reasonable information transfer that was proposed to correct any suggested inequities here.

I think withholding, on the other hand—and here I put the hat of the investor on—would be unfair and discriminatory, and administratively burdensome absent Treasury's documented case history of some abuse, which I don't think can be found.

There were issues raised of either not allowing a loss pass-through or taxing MLP income as portfolio income: I think that

both probably wouldn't meet much opposition if suggested to members of the MLP community.

The industry does not generate a lot of taxable income, as my estimates indicated earlier, so I really think the thought of sheltering the income that they generate with passive losses is merely an intellectual or a fictitious exercise. The last figures I saw from Treasury were that there's \$25 billion of losses in limited partnerships for 1983. It's hard to shelter them with \$229 million of taxable income.

[Material submitted by Mr. Stanger follows:]

ROBERT A. STANGER & CO.
1129 BROAD STREET
P.O. BOX 7490
SHREWSBURY, NEW JERSEY 07701
(201) 380-3600

ROBERT A. STANGER
CHAIRMAN OF THE BOARD

June 26, 1987

Committee on Ways and Means
U.S. House of Representatives
Room 1100
Longworth House Office Building
Washington, D.C. 20515

Dear Sirs:

I have attached material describing (1) the amount of equity raised in publicly in MLPs and untraded partnerships since January 1, 1986 (Table I), (2) the breakdown of MLPs by industry, showing taxable income (Table II) and (3) the universe of all outstanding MLPs as of June 12, 1987 (Tables III-VI).

Table I shows the peak offering period for MLPs was the fourth quarter of 1986 (probably in anticipation of the repeal of the General Utilities Doctrine). Also, no particular connection appears to exist between initial issuance of MLPs and untraded limited partnerships. Finally, MLP activity will probably increase in 1987 versus 1986. Our estimate is \$3.7 billion of initial offerings of MLPs in 1987 versus \$2.5 billion in 1986.

Table II shows the total capitalization of MLPs is \$31.5 billion, but the amount of MLP securities in public hands is only \$12.5 billion, or 40% of the total. The balance of ownership was retained by the corporate sponsors of MLPs. The result is that 60% of distributions from MLPs is subject to the corporate tax.

The distributions from MLPs to public shareholders is currently at the annual rate of \$1.1 billion, but, based on financial statement analysis, only 21%, or \$239 million, is taxable. (The balance of the distributions from MLPs are a return of capital which are not taxed upon receipt but reduce the tax basis of the investment.) Only the taxable portion of MLP distributions would be subject to the corporate tax if the corporate tax were applied to MLPs.

The following shows the potential revenue gain from taxing all currently outstanding MLPs as corporations:

ROBERT A. STANGER & CO.

-2-

June 26, 1987

Revenue Gain From Taxing MLPs
(millions)

<u>Revenue Before Imposition of Corporate Tax</u>		<u>Revenue After Corporate Taxes</u>	
MLP Taxable Income	\$ 239	MLP Taxable Income	\$ 239
x Individual Tax Rate	x 28%	x Corporate Tax Rate	x 34%
Individual Tax Due	\$ 67	Corporate Tax Due	\$ 81
		Net Income Available for Distribution	\$ 158
		x Individual Tax Rate	x 28%
		Individual Tax Due	\$ 44
Total Tax Due	\$ 67	Total Tax Due	\$ 125
	=====	(Corp. & Individual)	=====
Net Revenue Gain -- \$58 million			
=====			

The Net Revenue Gain estimate does not consider all the consequences of taxing MLPs as corporations. When assets are sold to a partnership, or transferred to a partnership by a corporation, a gain tax is due if the transfer price is in excess of cost, or book value. Taxing MLPs as corporations would discourage such transactions, reducing Federal revenues in the short run. We do not have data to estimate the gain tax payable in starting up the existing universe of MLPs.

Perhaps the policy alternative to taxing MLPs is to have a "related party" rule for the transfer of assets currently held in corporate form (like "related party" rules imposed when depreciable lives are shortened). If the new entity is substantially owned or controlled by the transferring corporation, the newer entity would be taxed like a corporation regardless of the form of business organization chosen for the entity.

Tables III-VI show various data for each outstanding MLP by industry category. This information is summarized in Table II.

We are pleased to make our data base about partnership securities available. If you would like additional information that we can supply, please let me know.

Sincerely,

Robert A. Stanger

TABLE I

INITIAL PUBLIC OFFERINGS OF PARTNERSHIPS

	1986				Cum Total	1987		Cum Total
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr		1st Quarter	April & May	
Untraded L. P.	\$2,189.8	\$3,128.0	\$2,054.2	\$3,290.6	\$10,662.6	\$2,618.0	\$1,647.6	\$4,265.6
MLPs	207.7	324.0	568.2	1,375.0	2,474.9	1,106.2	644.7	1,750.9
TOTAL	\$2,397.5	\$3,452.0	\$2,622.4	\$4,665.6	\$13,137.5	\$3,724.2	\$2,292.3	\$6,016.5

TABLE II

MP Category (3)	Number of MPs	Annual Distributions to IPs (000s)	Taxable Income to IPs (000s)	Equity Held by Public		Equity Held by GP		Total Equity (000s)
				\$ (000s)	% of MP Equity	\$ (000s)	% of MP Equity	
Real Estate - Equity	29	\$191,204	\$76,646	\$2,545,533	68.40%	\$1,175,920	31.60%	\$3,721,453
Real Estate - Mortgage Loan	10	111,199	86,287	1,201,157	97.68%	28,532	2.32%	1,229,689
Oil & Gas	34	565,666	29,450	5,360,564	27.26%	14,303,883	72.74%	19,664,447
Miscellaneous	17	121,497	25,510	2,002,706	56.01%	1,572,949	43.99%	3,575,655
Cable TV	3	22,180	0	209,692	79.79%	53,102	20.21%	262,794
Pipelines	4	77,450	13,650	884,897	62.82%	523,763	37.18%	1,408,660
Timberlands	2	33,009	7,883	295,013	18.45%	1,303,656	81.55%	1,598,669
TOTAL	99	\$1,122,205(1)	\$239,426(2)	\$12,499,562	39.73%	\$18,961,805	60.27%	\$31,461,367

(1) Excludes distributions where data on taxable income are not available.

(2) Excludes taxable income where data are not available.

(3) Details attached in Tables III-VI. Table VI contains the details for the categories of Miscellaneous, Cable TV, Pipelines and Timberlands shown above.

Real Estate - Equity

Table III

MLP Name	Activity	Exchange/Symbol	Annual Distributions to LPs	Innoble Income to LPs	Equity Held By Public	% Of MLP Equity	Equity Held By GP	% Of MLP Equity	Total Equity
			(000's)	(000's)	(000's)		(000's)		(000's)
Standard Pacific LP	Builder/Developer	NYSE/SF	\$25,270.00	\$28,512.00	\$251,208.00	80.60%	\$60,476.00	19.40%	\$311,684.00
UDC-Universal Development LP	Builder/Developer	NYSE/UDC	\$23,691.60	\$11,745.80	\$245,594.00	100.00%	\$0.00	0.00%	\$245,594.00
NY Homes	Builder/Developer	AMEX/NH	\$965.76	\$321.92	\$43,781.12	19.90%	\$176,256.00	80.10%	\$220,037.12
Interstate General Co. LP	Builder/Developer	AMEX/IGC	\$1,200.00	\$2,160.00	\$19,500.00	20.20%	\$77,025.00	79.80%	\$96,525.00
Universal Medical Buildings LP	Builder/Developer	OTC/UMBLZ	\$2,280.00	NA	\$39,444.00	40.88%	\$37,090.00	59.14%	\$96,534.00
Emerald Homes	Builder/Developer	NYSE/EHP	\$3,360.00	\$3,360.00	\$26,784.00	53.85%	\$22,512.00	46.15%	\$49,296.00
Southwest Realty	Builder/Developer	AMEX/SW	\$0.00	NA	\$8,191.96	100.00%	\$0.00	0.00%	\$8,191.96
Perkins Family Restaurants, LP	Fast Food	NYSE/PFR	\$6,120.00	\$3,672.00	\$52,938.00	50.50%	\$51,900.00	49.50%	\$104,838.00
Burger King Investors Master LP	Fast Food	NYSE/BKP	\$8,648.00	\$5,336.00	\$48,550.00	100.00%	\$0.00	0.00%	\$48,550.00
Winchell's Donut House LP	Fast Food	NYSE/WH	\$9,000.00	\$4,500.00	\$61,250.00	72.46%	\$23,275.00	27.54%	\$84,525.00
U. S. Realty Partners	Income Properties	OTC/USRLZ	\$3,079.44	\$0.00	\$23,376.86	100.00%	\$0.00	0.00%	\$23,376.86
Col Fed Income Partnership LP	Income Properties	NYSE/CFI	\$12,500.00	\$4,500.00	\$114,125.00	100.00%	\$0.00	0.00%	\$114,125.00
Gould Investors L.P.	Income Properties	AMEX/GLP	\$0.00	NA	\$66,280.50	100.00%	\$0.00	0.00%	\$66,280.50
Newhall Land and Farming Co.	Income Properties	NYSE/NHL	\$16,576.00	\$6,630.40	\$681,273.60	100.00%	\$0.00	0.00%	\$681,273.60
Newhall Investment Properties	Income Properties	NYSE/NIP	\$3,996.00	NA	\$41,070.00	100.00%	\$0.00	0.00%	\$41,070.00
Marina LP, The	Income Properties	OTC/MRLVZ	\$0.00	\$0.00	\$3,800.00	40.00%	\$5,700.00	60.00%	\$9,500.00
Prime Motor Inns LP	Hotels/Hotels	NYSE/PMI	\$8,000.00	\$0.00	\$78,520.00	100.00%	\$0.00	0.00%	\$78,520.00
Allister Inns, L.P.	Hotels/Hotels	AMEX/SAL	\$7,873.20	\$0.00	\$37,620.16	50.14%	\$37,304.00	49.86%	\$74,924.16
Red Lion Inns	Hotels/Hotels	AMEX/RED	\$9,880.00	\$0.00	\$87,092.20	100.00%	\$0.00	0.00%	\$87,092.20
La Quinta Motor Inns	Hotels/Hotels	NYSE/LQP	\$2,950.00	\$0.00	\$63,600.00	100.00%	\$0.00	0.00%	\$63,600.00
Hotel 6, LP	Hotels/Hotels	NYSE/SLX	\$7,320.00	\$0.00	\$78,000.00	12.30%	\$556,348.00	87.70%	\$634,348.00
National Healthcorp LP	Nursing/Retirement	NYSE/NHC	\$1,900.00	\$4,408.00	\$51,150.00	47.83%	\$55,800.00	52.17%	\$106,950.00
Forum Retirement Partners	Nursing/Retirement	AMEX/FRL	\$6,800.00	\$0.00	\$61,250.00	86.21%	\$9,800.00	13.79%	\$71,050.00
Angell Care Master Limited Partnership	Nursing/Retirement	NYSE/ACR	\$5,396.00	\$1,420.00	\$49,274.00	100.00%	\$0.00	0.00%	\$49,274.00
Enville Real Estate Shopping Centers	Shopping Centers	NYSE/EN	\$10,700.00	\$0.00	\$100,366.00	100.00%	\$0.00	0.00%	\$100,366.00
EDM Green Acres LP	Shopping Centers	NYSE/EGA	\$9,783.60	\$0.00	\$73,000.00	91.18%	\$9,000.00	8.82%	\$82,000.00
Shoppo Laurel Centre	Shopping Centers	AMEX/LSC	\$4,660.00	\$0.00	\$41,940.00	100.00%	\$0.00	0.00%	\$41,940.00
Ala Moana Hawaiian Properties	Unimproved Land	NYSE/ALA	\$0.00	\$0.00	\$6,346.00	100.00%	\$0.00	0.00%	\$6,346.00
Royal Palms Beach Colony Limited Partnership	Unimproved Land	AMEX/RPB	\$0.00	NA	\$10,727.72	44.40%	\$13,433.86	55.60%	\$24,161.58
Gross Total			\$197,479.60	\$76,646.12	\$2,545,533.12	68.10%	\$1,175,919.86	31.90%	\$3,721,452.98
Total Excluding "NA's" (1)			\$191,203.60	\$76,646.12					

Table IV

Real Estate - Mortgage Loan

MLP Name	Activity	Exchange/Symbol	Annual Distributions to LPs (000's)	Tangible Income to LPs (000's)	Equity Held By Public (000's)	% Of MLP Equity	Equity Held By GP (000's)	% Of MLP Equity	Total Equity (000's)
America First Tax Exempt Mortgage Fund 2	Mortgage Loan	OTC/ATM2	\$7,343.00	40.00	\$97,853.75	100.00%	40.00	0.00%	\$97,853.75
American Insured Mortgage Investors	Mortgage Loan	OTC/ATM84	\$15,200.00	\$15,200.00	\$182,500.00	100.00%	40.00	0.00%	\$182,500.00
CRI Insured Mortgage Investments	Mortgage Loan	NYSE/CRM	\$17,028.00	\$17,200.00	\$175,268.00	86.00%	\$28,532.00	14.00%	\$203,800.00
American Insured Mortgage Investors Series B5	Mortgage Loan	OTC/ATM85	\$17,908.00	\$17,908.00	\$217,800.00	100.00%	40.00	0.00%	\$217,800.00
America First Federally Guaranteed Mortgage Fund	Mortgage Loan	OTC/ATM87	\$10,098.40	\$9,321.60	\$89,817.50	100.00%	40.00	0.00%	\$89,817.50
Angeles Finance Partners	Mortgage Loan	AMEX/ANF	\$1,980.00	\$1,980.00	\$19,668.00	100.00%	40.00	0.00%	\$19,668.00
Wintthrop Insured Mortgages II	Mortgage Loan	AMEX/INTI	\$5,415.20	\$5,415.20	\$52,218.00	100.00%	40.00	0.00%	\$52,218.00
America First Tax Exempt Mortgage Fund	Mortgage Loan	OTC/MTM2	\$16,964.30	40.00	\$197,085.25	100.00%	40.00	0.00%	\$197,085.25
VMS Mortgage Investors L.P. II	Mortgage Loan	OTC/MTM2	\$11,022.88	\$11,022.88	\$108,471.00	100.00%	40.00	0.00%	\$108,471.00
VMS Mortgage Investors LP	Mortgage Loan	OTC/MTM2	\$8,239.32	\$8,239.32	\$72,475.50	100.00%	40.00	0.00%	\$72,475.50
Gross Total			\$111,199.10	\$86,287.00	\$1,201,157.00	97.68%	\$28,532.00	2.32%	\$1,229,689.00
Total Excluding "M's" (1)			\$111,199.10	\$86,287.00					

(1) Excludes MLPs for which tangible income data are not available.

Oil & Gas

Table V

NP Name	Activity	Exchange/Symbol	Annual Distributions to LPs (000's)	Income to LPs (000's)	Equity Held By Public (000's)	% of NP Equity	Equity Held By GP (000's)	% of NP Equity	Total Equity (000's)
Leak Petroleum Partners, LP	Oil & Gas	AMEX/LPP	10.00	12,664.63	4.49	95.51	154,206.37	95.51	154,206.37
Dorchester Holdings, LP	Oil & Gas	OTC/HHZ 2	17.00	17,000.00	100.00	100.00	10.00	0.00	100.00
Graham McCormick Oil & Gas Partnership	Oil & Gas	AMEX/OGP	10.00	115,184.00	91.01	8.99	11,500.00	8.99	115,184.00
Walker Energy Partners	Oil & Gas	NYSE/WEP	10.00	171,895.00	100.00	100.00	10.00	0.00	100.00
Greif American Partners	Oil & Gas	OTC/GAPR2	12,374.00	114,125.30	94.47	5.53	1835.38	5.53	114,960.68
Entex Energy Development, Ltd.	Oil & Gas	NYSE/EEI	14,029.00	128,538.75	71.28	28.72	111,496.25	28.72	140,035.00
Entex Energy Partners, Ltd.	Oil & Gas	NYSE/EEP	115,501.60	10,000,917.50	13.34	86.66	11,363,537.50	86.66	11,579,455.00
Enserch Exploration Partners, Ltd.	Oil & Gas	NYSE/ESD	117,058.40	11,811.48	100.00	100.00	10.00	0.00	100.00
Sunder Oil Partners	Oil & Gas	NYSE/SOP	116,540.00	126,500.00	19.69	80.31	1515,900.00	80.31	1642,400.00
Santa Fe Energy Partners	Oil & Gas	NYSE/SFP	17,006.40	17,006.40	17.99	82.01	193,250.95	82.01	1111,711.11
Kareb Energy Partners, Ltd.	Oil & Gas	AMEX/KLY	13,378.00	12,297.04	97.17	2.83	11,113.00	2.83	13,870.14
Keller Oil & Gas Partners, Ltd.	Oil & Gas	AMEX/KOP	11,942.80	10,000,232.50	79.29	20.71	15,287.50	20.71	125,525.00
Sasoon Energy Co. LP	Oil & Gas	NYSE/SAP	120,289.80	10,000,156.67	22.69	77.31	1663,026.86	77.31	1857,583.53
Fresnost Indian Energy Partners, Ltd.	Oil & Gas	NYSE/FIP	12,629.80	10,000,161.00	100.00	100.00	10.00	0.00	100.00
Hubbell Resources, Ltd.	Oil & Gas	NYSE/HBP	116,168.00	10,000,162,368.00	3.62	96.38	14,370,555.84	96.38	14,482,923.84
Union Exploration Partners, Ltd.	Oil & Gas	NYSE/UEP	112,340.00	10,000,117,300.00	100.00	100.00	10.00	0.00	100.00
UAC United Partnership	Oil & Gas	OTC/UEP2	112,438.50	10,000,118,045.25	100.00	100.00	10.00	0.00	100.00
Nesha Limited Partnership - Preference A	Oil & Gas	NYSE/NLPA	113,035.00	NA	94.05	5.95	17,125.00	5.95	117,700.00
Energy Development Partners, Ltd.	Oil & Gas	AMEX/EDP	16,251.60	10,000,197,837.54	93.53	6.47	16,742.02	6.47	1104,579.56
MM Energy Company, LP	Oil & Gas	NYSE/MM	19,510.00	10,000,117,442.75	2.61	97.39	15,505,165.00	97.39	15,652,807.75
Sun Energy Partners	Oil & Gas	NYSE/SUP	116,077.00	112,800.00	72.27	27.73	147,569.50	27.73	171,569.50
North Energy Company, LP-APU	Oil & Gas	AMEX/NEP	10.00	10,000,125,000.00	97.68	2.32	1400.00	2.32	125,650.00
Danison Energy A	Oil & Gas	AMEX/DEP-A	10.00	10,000,136,658.14	27.91	72.09	189,778.00	72.09	11,206,436.14
Transco Exploration Partners, Ltd.	Oil & Gas	NYSE/TEP	136,172.28	10,000,130,296.00	100.00	100.00	10.00	0.00	100.00
Petroleum Investments, Ltd.	Oil & Gas	NYSE/PIL	12,160.44	10,000,116,906.54	83.07	16.93	13,457.32	16.93	120,363.86
Belton & Blake Energy Co.	Oil & Gas	AMEX/BEC	11,103.20	10,000,133,264.00	93.83	6.17	122,304.50	6.17	136,184.50
Anacostia Petroleum Company	Oil & Gas	NYSE/APC	130,643.20	10,000,116,656.50	86.79	13.21	11,893.50	13.21	118,550.00
Conquest Energy Partners, Ltd.	Oil & Gas	AMEX/CEP	1534.32	10,000,17,547.27	27.92	72.08	119,485.72	72.08	127,032.99
Sun Oil Development Partners LP	Oil & Gas	NYSE/SODP	13,615.70	16,920.00	100.00	100.00	10.00	0.00	100.00
Sunder Oil Partners-Preference A	Oil & Gas	NYSE/SOP-A	13,640.00	10,000,115,544.00	13.30	86.70	1712,509.00	86.70	1872,053.00
Diamond Shamrock Offshore Partners	Oil & Gas	NYSE/DSOP	13,640.00	10,000,11,261,966.20	94.94	5.06	167,269.00	5.06	11,329,175.20
Nesha Limited Partnership	Oil & Gas	NYSE/NLP	1161,480.00	1908.60	100.00	100.00	124,441.34	27.64	133,775.64
Down Resource Investors	Oil & Gas	AMEX/DRI	12,275.80	16,492.20	100.00	100.00	10.00	0.00	100.00
North Energy Company, LP - Preferred	Oil & Gas	AMEX/NEP-B	16,492.20	16,492.20	100.00	100.00	10.00	0.00	100.00
Danison Energy B	Oil & Gas	AMEX/DEP-B	10.00	10,000,121,804.00	100.00	100.00	10.00	0.00	100.00

Gross Total 179,449.68 \$5,360,563.81 27.26% 114,303,882.51 72.74% 119,644,446.32

Total Excluding "NA's" (1) 179,449.68 \$5,360,563.81 27.26% 114,303,882.51 72.74% 119,644,446.32

Table VI

Other

M.P. Name	Activity	Exchange/Symbol	Annual Distributions to LPs	Tangible Income to LPs	Equity Held By Public	% of M.P. Equity	Equity Held By GP	% of M.P. Equity	Total Equity
			(000's)	(000's)	(000's)		(000's)		(000's)
Airlease Limited	Aircraft Leasing	NYSE/FLY	\$7,776.00	\$1,440.00	\$63,900.00	77.84%	\$18,193.75	22.16%	\$82,093.75
Cedar Fair, LP	Amusement Parks	NYSE/FIM	\$16,640.00	\$8,320.00	\$158,080.00	75.61%	\$31,000.56	24.39%	\$209,080.56
Jones Interchange Investors LP	Cable TV	AMEX/JIV	\$10,768.00	40.00	\$89,172.50	84.97%	\$15,767.50	15.03%	\$104,940.00
Galaxy Cablevision, L.P.	Cable TV	AMEX/GTV	\$2,772.00	40.00	\$42,000.00	95.45%	\$2,000.00	4.55%	\$44,000.00
Falcon Cable Systems	Cable TV	AMEX/FAL	\$8,640.00	40.00	\$78,520.00	68.97%	\$35,334.00	31.03%	\$113,854.00
Intelligent Systems Master LP	Computer Software	AMEX/ISP	\$8,500.00	NA	\$56,355.00	87.63%	\$7,956.00	12.37%	\$64,311.00
FFP Partners L.P.	Conv.Store/Gas Stat.	AMEX/FFP	\$3,000.00	\$940.00	\$23,500.00	54.79%	\$19,387.50	45.21%	\$42,887.50
Perian Partners, L.P.	Crude Oil Pipeline	NYSE/PPR	\$16,847.50	NA	\$131,850.00	51.92%	\$122,005.00	48.08%	\$253,855.00
Tenera LP	Engineering Services	OTC/PPZ	\$7,098.40	NA	\$73,202.25	100.00%	40.00	0.00%	\$73,202.25
USA Cakes LP	Fast Food	AMEX/USF	\$5,200.00	NA	\$61,750.00	100.00%	0.00%	0.00%	\$61,750.00
Vista Organization Partnership LP, The	Films	OTC/VPRZ	40.00	NA	\$30,508.00	98.31%	\$56.00	1.69%	\$31,034.00
Delaware Film Partners LP	Films	NYSE/DFP	\$666.25	NA	\$16,055.00	66.33%	\$8,151.00	33.67%	\$24,206.00
Volero Natural Gas Partners	Gas Pipelines/Proc.	NYSE/NLP	\$23,750.00	40.00	\$216,175.00	51.91%	\$200,200.00	48.09%	\$416,375.00
Sun Distributors LP	Industrial Products	NYSE/SOP	\$11,724.90	NA	\$97,316.67	63.98%	\$54,780.00	36.02%	\$152,096.67
Reich & Tang	Investment Services	NYSE/RTP	\$3,520.00	NA	\$40,150.00	22.00%	\$142,350.00	78.00%	\$182,500.00
Petrolane Partners, L.P.	LP Pipelines/Distr.	NYSE/LPG	\$27,300.00	\$13,650.00	\$271,362.00	57.77%	\$198,800.00	42.23%	\$470,162.00
Mama Lou Macadamia Partners LP	Macadamia Orchards	NYSE/MOT	\$4,830.00	\$2,392.00	\$47,748.00	100.00%	40.00	0.00%	\$47,748.00
Fresport-Robison Resource Partners	Minerals	NYSE/FRP	\$27,240.00	40.00	\$205,775.50	18.51%	\$905,974.23	81.49%	\$1,111,749.73
Commonwealth Mortgage of America LP	Mortgage Services	NYSE/CMA	\$13,000.00	40.00	\$112,190.00	37.14%	\$189,860.00	62.86%	\$302,050.00
Buckeye Partners LP	Petroleum Pipelines	NYSE/BPL	\$26,400.00	40.00	\$265,540.00	99.00%	\$2,677.73	1.00%	\$268,217.73
Serviceaster LP	Property Management	NYSE/SVM	\$30,996.00	\$12,398.40	\$853,875.00	87.50%	\$121,975.00	12.50%	\$975,850.00
Family Group Broadcasting, L.P.	Radio/TV Stations	OTC/FGRP	\$805.00	40.00	\$12,512.00	100.00%	40.00	0.00%	\$12,512.00
Boston Celtics LP	Sports Franchise	NYSE/BOC	\$3,640.00	40.00	\$34,788.00	40.63%	\$50,844.00	59.38%	\$85,632.00
Rayonier Timberlands LP	Timberlands	NYSE/LOG	\$13,156.00	40.00	\$102,465.00	25.30%	\$302,535.00	74.70%	\$405,000.00
IP Timberlands, Ltd.	Timberlands	NYSE/IPT	\$19,853.28	\$7,682.92	\$192,547.62	16.13%	\$1,001,121.00	83.87%	\$1,193,668.62
Nortrans Partners, L.P.	Tugs & Barges	NYSE/TUG	\$13,570.00	40.00	\$115,050.00	98.33%	\$1,950.00	1.67%	\$117,000.00
Gross Total			\$307,493.33	\$47,043.32	\$3,392,307.54	49.55%	\$3,453,468.27	50.45%	\$6,845,775.81
Total Excluding "NA's" (1)			\$254,136.28	\$47,043.32					

Chairman RANGEL. Let me thank this panel. I think we got a lot accomplished. I appreciate your concern for what we're doing here. I think, Mr. Stanger, Treasury made it abundantly clear that this is not a revenue-raiser, so we don't have the urgency in the reconciliation to look at it for that purpose. We are concerned with good tax policy, and that is the only reason why it's before this committee.

Let me thank you.

I do have questions which I will be submitting through staff to you.

There is a vote on, as you can see and hear. And I thank you for your contribution.

The last panel will be meeting in 15 minutes at 3:15.

[Recess.]

Chairman RANGEL. The committee will resume its hearings.

The final panel will include: James Lovett, who's a partner in Coopers & Lybrand, and he'll be accompanied by John Furst and Alan Barber, both partners; Edward Oelsner, managing director, investment banking with Dean Witter Reynolds; William Nicoletti, senior vice president, E.F. Hutton; Robert Milburn, partner and director, real estate with Laventhol & Horwath; and George Robinson, partner with Peat Marwick & Mean. I apologize for the delay, but we certainly are glad that you've taken time out of your busy schedules to share your observations on the master partnership bill with us.

Suppose we start with Mr. Lovett.

STATEMENT OF JAMES R. LOVETT, PARTNER, COOPERS & LYBRAND, ACCOMPANIED BY JOHN S. FURST AND ALAN T. BARBER, PARTNERS

Mr. LOVETT. Thank you, Mr. Chairman.

My name is Jim Lovett, and I'm a partner with Coopers & Lybrand. I'm accompanied today by two of my tax partners, John Furst and Alan Barber.

We would like to comment on the Federal tax compliance aspects of publicly traded partnerships.

Coopers & Lybrand have provided accounting, tax, and system consulting services to 35 existing or proposed MLP's since the first year of such entities, 1981.

Today we've heard a number of individuals testify concerning the difficulties associated with tax compliance in a publicly traded partnership environment. Our written statement addresses three areas: the impact of the nominee reporting provisions of the Tax Reform Act of 1986, the need for regulations under Internal Revenue Code section 704(c), and how existing sophisticated computer software simplifies the complex and voluminous calculations required in an MLP environment.

Since 1981 the single most frustrating aspect of tax reporting for an MLP has been street name ownership; that is: how does one furnish a k-1 to each of the partners who owned interest in an MLP during the year when the general partner does not know who those partners are? Our clients have invested considerable time and dollars attempting to penetrate street name ownership. By sending

out requests for information to nominees, who in turn have passed on these requests to the beneficial owners, our clients have been successful at identifying a significant percentage of the beneficial owners.

This effort, when coupled with the use of per unit per month tables, has resulted in most partners receiving tax information. This process has, of course, not been 100-percent effective.

With the enactment of Internal Revenue Code section 6031(c) as part of the Tax Reform Act of 1986, Congress has provided the mechanism to eliminate the problems associated with street name ownership. Section 6031(c), and advance notice 8710, require nominees to furnish beneficial ownership information to publicly traded partnerships so that tax information can, in turn, be furnished directly to the interest owners.

Section 6031(c) has resulted in significant system modification efforts being undertaken by the nominees. Additionally, representatives of certain of the nominees, the MLP's, and the accounting firms, have participated in a series of meetings designed to facilitate the development of a clearing house system to collect the data from the nominees and disseminate appropriate information to each individual MLP on a timely and convenient basis.

While still under development, these systems being implemented in response to section 6031(c) should significantly improve an MLP's ability to furnish each partner a k-1. Additionally, as Alan or John can discuss, once these systems are in place nominee reporting also means that MLP's can more easily report the effects of basis adjustments required by the section 754 election, more easily monitor trading activity for section 708 purposes, and more readily report section 751 information.

Two other areas perceived as making compliance difficult or worthy of comment: fungibility of interests, and volume of trading and financial activity. MLP units are bought and sold through securities brokers, and our securities market has no mechanism to match purchasers and sellers. For this reason it is imperative that all units traded be fungible, that is, all of a given class of partnership units selling in the market place must have substantially the same tax attributes. As Alan or John can discuss, the difficulty is fungibility in light of the compliance requirements of section 704(c). We believe compliance can be achieved with further guidance in the form of regulations under 704(c).

Finally, we do not view the high volumes of partners or transactions present in a typical MLP as being compliance obstacles. There is sophisticated computer software designed to accommodate the specific calculations required by an MLP. This software is quite capable of producing accurate tax results regardless of volume or complexity.

In summary, we are here to testify that, based on our experience, we believe that MLP's can effectively comply with Federal tax laws.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Lovett follows:]

WRITTEN TESTIMONY

John S. Furst - Regional Tax Director, Southwest Region
 James R. Lovett, Partner
 Alan T. Barber, Partner
 Coopers & Lybrand

Hearings Before the Subcommittee on
 Select Revenue Measures on the Issue
 of Master Limited Partnerships
 Committee on Ways and Means
 U.S. House of Representatives
 June 30, 1987

Mr. Chairman and Members of the Committee, we are submitting for your consideration our testimony regarding the federal tax compliance by certain publicly traded partnerships. As an international accounting firm, Coopers & Lybrand has provided accounting, tax and system consulting services to thirty-five publicly traded partnerships since 1981.

A year ago, the Department of Treasury and others were concerned with the perception that a partnership entity with widely held and frequently traded ownership creates administrative complexities that make income tax compliance difficult. Among the most difficult rules to apply were those dealing with the termination of a partnership under section 708(b), the adjustment to the basis in partnership property where there is an election under section 754 in effect, the treatment as ordinary income under section 751 of certain amounts received from the sale of a partnership interest, and the tax items relating to contributed property required to be specially allocated under section 704(c). Some have even suggested that these administrative complexities are of a degree that compliance with these rules is impossible.

We acknowledge that even after the Tax Reform Act of 1986 (The Act), compliance for such an entity is certainly more difficult than when a partnership has a small number of owners who if not directly involved are at least closely aware of the activities of the partnership. But it is not an impossible task. Unmistakably, the administration of these large publicly traded partnerships or Master Limited Partnerships (MLPs) as they are commonly referred to, is complex and can be quite costly. Nevertheless, many of our clients continue to choose to operate as a MLP. In doing so these entities have not decided to ignore compliance with income tax laws but rather to accept the additional burdens and expense required to comply. This is a decision not entered into lightly and is one of the many reasons that not all businesses will operate in MLP form.

What specifically about the MLP amplifies the difficulty in tax compliance and what impact does The Act have? Why is a partnership that is widely held and frequently traded but is in all other respects like any other partnership faced with compliance issues that all other partnerships are not? In our view there are several fundamental reasons for this compliance difficulty.

- o First, is the fact that some of the partnership interests are held in street name. In such instances the MLP may not know who all the beneficial owners are behind the street name.
- o Secondly, when a taxpayer purchases an interest in a MLP through a securities broker, there is no mechanism to identify from whom the taxpayer has purchased his interest. Therefore, it is imperative that partnership interests be fungible in a tax sense. That is, all of a given partnership's interests selling in the market need to have tax attributes substantially the same. At the same time, tax provisions which require that varying sets of tax attributes

be associated with different partnership interests appear to conflict with the need for fungibility.

- o Lastly, the sheer volume of partners a MLP reports to adds a layer of complexity not typically experienced by the non publicly traded partnership.

The following closer analysis of these factors, will demonstrate how compliance can be achieved in the wake of the 1986 Tax Act.

Over the six years MLPs have existed, one of the most difficult issues has been one most basic yet not specifically cited by Treasury as a problem -- perhaps because it is somewhat obvious on its face. Where some of the beneficial ownership is held in street name and unknown to the partnership, it is rather difficult to provide each partner with a copy of the information on the partnership return as required by regulation. Some method to identify all partners is necessary to meet the requirements of section 6031. The solution to this deficiency is not to eradicate a MLP as an alternative form of doing business, as the Treasury Department advocated one year ago, but rather to cure the defect. This problem is not too different from that which would exist if a corporation were not required to furnish Form 1099 DIV notifying a shareholder of dividend income. Would the corporation notify the shareholder absent a legal requirement? Would the shareholder fail to report the income? If so, would it be correct to eliminate the corporate entity as an alternative under the tax laws? Obviously not. The reasonable solution has been to require the corporation to provide the necessary information to the shareholder to help facilitate compliance.

Provisions requiring certain persons or entities to furnish taxpayers information necessary to help insure compliance with the tax laws comprise a significant part of the Internal Revenue Code. In June of 1986 members of the Securities Industry Association, representatives of various MLPs, and certain tax practitioners requested legislation that would require nominees to provide necessary information relating to beneficial owners. Accordingly, Congress responded in the Tax Reform Act of 1986 with the nominee reporting requirements of Internal Revenue Code section 6031(c). These requirements are effective for years beginning after enactment of the legislation. Thus, on a prospective basis, nominees should be reporting to the partnership information relating to the beneficial owner. We believe that nominee reporting is appropriate and presently we have no reason to believe that systems will not be in place to enable nominees to comply in 1987.

Aside from now knowing who all the beneficial owners are and thus enabling the partnership to provide each partner with a Schedule K-1, what impact will nominee reporting have? Specifically it will simplify compliance in three of the problem areas: terminations of partnerships under section 708(b), adjustments required where a section 754 election is in effect, and reporting of ordinary income under section 751. Certainly, by requiring the nominee to provide the necessary information about the beneficial owner, the partnership can now more easily account for 100 percent of its ownership and monitor changes determining if and when 50 percent or more of the partnership interests have been sold or exchanged within a 12 month period constituting a technical termination. Once the partnership knows the event has occurred, it may then comply with the requirements prescribed in Subchapter K for such an event.

It should be noted that even prior to nominee reporting, MLPs made a good faith effort toward providing beneficial owners some tax information. The MLPs customarily provided nominees tables with per unit per month tax results which if forwarded to the beneficial owner through the nominee enabled him to construct his K-1 information and report his distributive share. This, however, had limitations where a section 754 election had been made requiring adjustments under sections 734 and 743. The adjustments are determined in part by the partner's outside tax basis which is largely a function of the partner's purchase price for his interest. Where the partners were unknown, and, therefore, they

received tables instead of individually prepared Schedule K-1s, a simplifying assumption was required with respect to the adjustments in the tables provided. The assumptions were conservative and in most instances produced results not materially different from what actually would occur. Nominee reporting should, for two reasons, eliminate any need for assumptions. First, there will no longer be a need to provide tables to the nominees. By knowing who all the partners are, the partnership can furnish each with an individualized Schedule K-1 and appropriate supporting schedules. Secondly, actual prices paid for partnership interests may be obtained and thus actual outside tax basis determined.

In the past there has been concern over the ability to properly apply section 751 to publicly traded partnerships because the partner has insufficient knowledge regarding the partnership's property. Even before The Act's impact, we do not believe the problem with section 751 was as extensive as Treasury perceived. There were some deficiencies, however. As previously mentioned, MLPs have provided nominees with per unit tables. A limitation of those tables has been that the actual amount of section 751 income which is often unique to a given partner could not be reported accurately. As a practical matter, most partners in any partnership will only have sufficient knowledge to comply with section 751 if the partnership provides them such information. Curiously, current law and regulations do not appear to expressly require the partnership to provide this information. Admittedly, with as many transfers as occur in a publicly traded partnership, providing such information might seem a monumental task. In an attempt to insure compliance wherever possible, most MLPs voluntarily provide such information to the partners when an interest is transferred. This goes far beyond what most other partnerships (whether small or large) customarily provide and apparently beyond what the law even requires of the partnership.

As is the case with the section 754 election, The Act through nominee reporting should eliminate the problem with section 751 that existed with the street name investors. When the partnership can account for all partners and all sales or exchanges it can report the appropriate amount of section 751 income. Additionally, the elimination of the preferred rate for capital gains by The Act eliminates the impact of section 751 for most partners.

Another concern has been the perceived conflict between fungibility and compliance with section 704(c) where the partnership has contributed property with a value different from its tax basis. A substantial part of the difficulty in complying with section 704(c) emanates from the absence of regulations offering sufficient guidance. Taxpayers and practitioners are left to interpret for themselves precisely what section 704(c) does or does not require in the way of compliance. The legislative history directs one to rely upon the regulations under old law where section 704(c) was elective. Given the mandatory nature of this provision under current law, a set of examples are required that are more comprehensive than the few simplistic examples provided in the existing regulations. The legislative history also makes it quite clear as to the intent of section 704(c). We as practitioners are satisfied that MLPs have implemented methods of allocations that comply with the spirit of the statute and protect the Treasury from unintended revenue loss and that also preserve the critical tax fungibility required for the interests to be freely tradeable.

Certainly, one specific need that a MLP has and that volume tends to aggravate is the computation of each transferee partner's basis adjustments where the partnership has made a section 754 election. The frequency with which such adjustments must be made and the number of assets over which the adjustments must be allocated are precisely why a MLP must have specially designed computer programs. These programs are capable of calculating and allocating the adjustments with great accuracy and without relying upon simplifying assumptions as the Treasury Department has suggested.

Perhaps more traditional tax accounting and reporting systems are inadequate to deal with the volumes presented by the MLP. Fortunately, MLPs are not required to rely upon these methods or systems. Sophisticated software has been developed to accommodate the specific needs of a MLP and particularly those needs that are unique to the problems of high volume. Indeed, it has been observed that the reason MLPs did not exist before 1981 was because computer technology had not advanced to a stage where these complexities could be handled in a cost effective manner.

Conclusions

The three basic areas of concern expressed as problems with compliance have been or can be overcome for MLPs.

- o Street name or lack of information for beneficial owners has been largely solved by The Tax Reform Act through section 6031(c).
- o The need for fungibility and its impact on compliance may be dealt with by MLPs when given guidance through regulations.
- o Sheer volume and most other complexities can and are being addressed by sophisticated software.

In summary, we are here to testify that from our experience we believe that MLPs can effectively achieve compliance with federal tax laws.

Chairman RANGEL. Thank you, Mr. Lovett.
Mr. Oelsner.

**STATEMENT OF EDWARD C. OELSNER III, MANAGING DIRECTOR,
INVESTMENT BANKING, DEAN WITTER REYNOLDS, INC.**

Mr. OELSNER. Thank you.

My name is Edward Oelsner. I work for Dean Witter Reynolds Inc.

By our records, MLP offerings since 1982, have raised \$6.3 billion of equity capital. Our participation has been as manager or co-manager of 31 MLP offerings that have accounted for \$3.5 billion of equity offered to the public. Our own sales, through our branch system primarily to individual investors, have been slightly in excess of \$1 billion.

I guess I present myself here as a practitioner. I do get very discouraged by Mr. Mentz' comments and much of what I read in the press about MLP's, such as, "MLP's have no economic basis other than to avoid double taxation. MLP's cause revenue losses to the Treasury. Implementation of passthrough rules is impossible, and hence compliance and reporting are not feasible." I would disagree on all counts.

Neither Mr. Mentz or other critics have had to structure or sell an MLP to the public. MLP's are new. They are different. But they represent an extremely attractive cost-effective equity vehicle which produces a higher value for the issuer's underlying assets than is currently available in the market place.

My testimony goes into detail on that, but I'd like to make several points. First, Treasury does not understand the market place. Our MLP's have been formed for valid business purposes. Access to a new set of investors for long-term equity has afforded more economic benefits to our issuers than any other equity alternative under consideration. In some cases the MLP route, the equity route, represented the only prudent or possible source of capital, debt, or equity.

Other than a rush of a few publicly traded corporations prior to year-end 1986 to complete corporate to partnership restructurings, thereby avoiding the implications of the repeal of the *General Utilities* doctrine, the use of the MLP has not been accelerated by the 1986 Act.

For those concerned with revenue loss, the corporate alternatives to our recent MLP version should be of greater concern to you than the use of our MLP's. Without the availability of the MLP, prospective issuers may resort to additional debt, greater retention of earnings, or cancellation of projects rather than proceeding with the sale of their most costly equity security, their common stock.

Consequently, we think MLP's have been revenue effective on balance and have not eroded Treasury's revenue base, contrasted to the other alternatives available to these issuers.

The MLP yield evaluation model is extremely efficient for those that fit, but the implications of any valuation model based on maximum cash payout to individual investors would suggest that there are not that many eligible candidates for this form of financing.

MLP's will be sold primarily to the individual investor as a high cash yield, fixed income, equity-type investment with the primary emphasis on cash. The market is paying for current cash, and not tax loss.

With over 70 percent of the MLP issues trading below their original offering prices, we do not see an open-armed market beckoning us to produce a lot more of these vehicles. The market is policing itself.

The MLP, as an investment vehicle, has widened an issuers access to a broader investor group which previously could not participate in most of our nontraded partnerships as a result of high net worth and high income requirements. It's a whole totally different investor base that we're dealing with here.

This valuation process and resulting MLP financial structure requires that the capital structures of the MLP will need to be more conservative; that is, capitalized with less debt than their corporate counterparts—and their cash payouts to their investors well in excess of such corporate counterparts.

The pricing and structure of the MLP's suggest institutional interest will remain minimal, further restricting the market ability for these issues, and the number and size of issues since the loss of access to institutional equity serves as the single most major deterrent to widespread use of MLP's after first looking at the economics.

Wall Street does recognize the added difficulty with regard to MLP tax reporting. We are working to cure this problem, and we will work to solve any problem that the Treasury or the Internal Revenue Service may raise.

The MLP, as a new financing vehicle, may have some wrinkles that need to be worked out, but we will work them out.

Thank you.

[The prepared statement of Mr. Oelsner follows:]

Statement of Edward C. Oelsner, III
Before The
House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures
Hearings on the Issue of Master Limited Partnerships
June 30, 1987

My name is Edward C. Oelsner, III. I am a Managing Director in the Investment Banking Department of Dean Witter Reynolds Inc. (DWR). As an investment banker for 19 years, my primary role has been to assist companies in raising long term capital in the most efficient manner possible. My first association with a master limited partnership (MLP) commenced with Transco Exploration Partners, Ltd.'s offering of partnership units to the public in July 1983, and I have devoted a major part of my time since that offering reviewing, analyzing and assisting in structuring most of our MLPs (also referred to as publicly traded partnerships or PTPs). My firm, Dean Witter, has been involved with MLPs since 1982, initially co-managing the first MLP offering which was made by Apache Corporation in 1982. I am appearing here today on behalf of my firm to discuss my experience with publicly traded partnerships.

Dean Witter believes there are several popular -- but inaccurate -- perceptions about MLPs such as they have no economic basis other than to avoid "double taxation" at the entity and individual level. Stated differently, MLPs are "tax avoiders" or "tax loopholes". We disagree. We believe the MLP form provides certain issuers with certain types of assets a structure within which it can increase the value of these assets to its equity owners as a result of this efficient capital raising mechanism. MLPs offer individual investors an attractive equity investment vehicle and therefore afford issuers access to a broad investor group. We believe that the use of MLPs does not result in revenue losses to the Treasury.

My testimony will discuss the marketplace (buyers) for MLP equity securities, the MLP valuation process, the reasons issuers utilize the MLP form, the various financing alternatives considered by our recent MLP issuers, our perceptions of the revenue implications to the Treasury Department of our MLPs and the impact of the Tax Reform Act of 1986 on the use of the MLP and its effect on the marketplace.

The Marketplace

Since Apache Petroleum first sold MLP units publicly in November 1982, there have been 54 public MLP offerings of note (issue size \$40 million or larger) and the aggregate equity monies raised through all MLP offerings (77 issues) has amounted to \$6.3 billion of partnership equity. Over this same time period, in the public markets corporations have raised \$147.7 billion of corporate common equity through 4,672 offerings, \$45.2 billion of preferred stocks and \$651.3 billion of long term debt (corporate private equity and debt placements, and commercial paper and bank debt are excluded from these numbers; as well, corporate retention of earnings, which represents the major source of equity for corporate America, is excluded).¹

1/ Source: IDD Information Services Inc. In addition, other tabulations of MLPs may indicate a slightly higher number. Such tabulations would include several corporate conversions (not accompanied by a public offering) and some investment portfolio type partnerships which are the equivalent of a mutual fund and not classified by IDD as an MLP.

Of all these partnership offerings, 59 or 80% are trading at price levels below their original offering prices. If we exclude our oil and gas partnerships, only 34 or 69% are trading below their original offering prices. The average non-weighted yield is 10.9% for all our MLPs (includes only MLPs who have offered securities publicly); for oil and gas MLPs it is 11.4%. Over the same time period, our corporate market equity averages have moved up from 803.27 to above 2,400 (DJIA) and 108.71 to 306.97 (S&P 500) with indicated current yields approximating 2.9% (5/87) DJIA for these averages. The current average yield for 80 major electric utilities which is an excellent barometer for yield oriented equity securities is 7.9% (6/12/87). Long term Treasury bonds and tax exempt industrial revenue bonds yield approximately 8.45% (30 year Treasury) and 8.1% (15 year revenue bond). Clearly our partnership equity trades at a yield premium to other widely traded public equity and debt investment alternatives. An analysis of partnership equity ownership illustrates that the owners are primarily individuals, contrasted to predominant institutional interest in corporate equity securities. In fact, these MLP securities have been sold predominantly to the individual investor as a fixed income equity type investment with its primary emphasis on current return, with institutional participation reserved for a select few "growth" MLPs. The securities are sold to these investors to be held as intermediate or long term investments, and not as short term trading vehicles.

Our own distribution records support these observations. DWR has participated as a manager in 31 MLP public offerings since 1982, selling approximately \$1.1 billion of PTP equity through our own branch system almost entirely to individual investors; that is a healthy 41% of all the offerings and approximately 17% of all the equity capital raised in these offerings. We estimate that the average sale for these offerings in our system is about 600 units or \$10,122 and the most frequent order size, or the mode, is around 200 units or \$3,289. Our experience is that MLP sales and trading in the marketplace are predominantly retail, not institutional. In fact, when you find evidence of institutional ownership with regard to any particular MLP, it more likely is the result of either existing institutional interest related to a conversion from corporate to partnership form or the distribution of units as dividends by a sponsoring corporation to its own shareholders, some of whom are institutional, contrasted to an institutional purchase in a public offering.

The Valuation Process

This reliance on the individual buyer should not be surprising as one notes the evolution of our MLPs and the valuation process applied in our equity markets. While issuers cite numerous reasons for the MLP, such as its usefulness as (1) a valuation vehicle, (2) an efficient equity capital raising tool, (3) a new financial currency, and (4) a form of takeover defense, the reasoning is somewhat circular: the MLP is first and foremost a valuation vehicle, but it does not conform to our classic corporate equity security evaluation model that assumes a dividend yield and an earnings retention which are necessary to provide the bases for growth in earnings and dividends over time. Instead, the MLP valuation is based on full payout of cash flow with minimal provision for retention of cash.

Without providing such valuation in the marketplace, there is no other reason for it to exist. Our oil and gas, timber and agricultural minerals natural resource partnerships most clearly illustrate this fact. Generally, their pretax cash flows have been sufficiently in excess of their corporate after-tax income to provide investors both double digit market yields and tax advantages resulting from the securities that we have designed which effectively prices the assets in the marketplace above that level which the market would

2/ For purpose of price and yield analysis, our sample was adjusted where a) price or yields were not available or b) significant distortions would result as a result of our "unweighted" calculations.

capitalize the assets in corporate form. As we have moved away from natural resource partnerships to other industries, the capitalization of cash flow available for distribution on a yield basis has been the critical determinant of value as contrasted to the price/earnings multiple which would have been accorded such issuer in corporate form.

With our natural resource publicly traded partnerships the first and most important factor for the new issue investor has been a high cash yield. In addition, the combination of a tax-free return of capital cash distribution and, a tax loss, has given individual investors an after-tax double digit current yield in many partnerships. These attributes continue to contrast favorably to other taxable and non-taxable publicly trading investment alternatives. However, under the Tax Reform Act of 1986, little or no value is given to any tax attributes in excess of return of capital treatment of cash distributions, and most value is given to pure cash yield, and in cases where pure cash yield exceeds that of government securities, one might expect to find an increase in institutional interest. However, the presence or prospect of unrelated business taxable income (UBTI) and the relative illiquidity of the marketplace has precluded significant institutional interest in cash offerings priced on a current yield basis. As a generalization, institutional investors believe future price appreciation has been priced out of most of our resource partnerships by the retail investor's focus on current yield. This same individual investor had been attracted by those same current yields in addition to the tax benefits, the liquidity of a NYSE traded unit, no minimum investment requirements and the ability to participate through a direct "ground floor" investment with a commodity hedge. Before the advent of the PTP, our individual investor generally did not have the financial ability to participate in partnership offerings. However, to obtain value represented by double digit yields requires distribution of most or all of the partnership's cash flow, imposing a heavy burden on the sponsor in the business entity to reinvest its own distributions or raise additional capital to replace resources. Without a combination of improving/stable finding or asset replacement costs and commodity price increases, value cannot be maintained. Look at the prices of our public oil and gas partnerships over the past two years and note the recent lack of public offerings for this industry.

The previous comments were specifically directed at our resource partnerships, but they provide the foundation of our approach to new industries. If a business entity's pretax cash flow and pretax income are relatively close together and the business historically has retained and needs to retain significant funds to continue its expansion, it will be impossible to produce both maximum value and high yields sufficient to retain the interest of the individual investor, related to other opportunities in the marketplace, as long as his focus remains primarily on current yield; and, since his focus has remained on current yield, it is difficult to avoid full payout partnerships. Consequently, if, heretofore, there has been any institutional interest related to their perception of growth/appreciation associated with this particular business activity such interest will dissipate when the activity is conducted in partnership form because: (1) such institutional investors will not believe growth can continue since such investors feel that management will be pressured by unitholders to retain less cash for growth since unitholders want the maximum amount of cash paid out and they do not want to pay taxes on cash they have not received; (2) the economic value of the switch to partnership form may not be great enough to mitigate the nuisance of filing state tax returns for one or two portfolio investments out of all their other corporate equity investments; and (3) the presence of unrelated business taxable income may force otherwise tax exempt institutions to pay taxes on their investment income, and certain of their accounts may have prohibitions against owning any form of partnership units. In summary, we have significant economic and institutionalized barriers which would restrict the number of potential MLP candidates and effectively limit the participation of major institutional investors.

The Use of the MLP and its Implications for Treasury Revenues

We have experienced a relatively short history in the evolution of our publicly traded partnerships but we can identify four distinct versions:

- 1) the "rollup",
- 2) the "rollout" (dropdown or transfer of assets),
- 3) the "acquisition MLP" (the public buyout, the asset sale, the equity buyout), and
- 4) the liquidation.

We think it is important to look at each form and understand why the issuer chose this route contrasted to other alternatives available. Once this is understood, one can develop a better understanding of the potential economic effect on Treasury Revenues from these PTPs and a better feel for the continued use of this partnership form.

"Rollups"

The "rollup" started with Apache Petroleum Company's exchange offer which was extended to holders of separate oil and gas limited partnerships previously sold by Apache Corporation in the private market to "high net worth" individual investors; the purpose of this and other rollups was to combine a number of limited partnerships into a larger publicly traded partnership to achieve a "critical mass" providing economic efficiencies, diversification of properties, reduced unitholder risk, a larger borrowing base and partners' liquidity (i.e., greater financial and operating integrity). Since the individual entities are already in partnership form, such a move initially can produce revenues to the Treasury through ITC recapture as the partnerships are reconstituted and, as a larger integral unit, the "rollup" MLP is intended to be more revenue productive than in its separate pieces. Rollups have been more prevalent in the oil and gas industry, which has traditionally used private partnerships to raise capital; currently, we are involved in an exchange offer related to several real estate limited partnerships. In any event, these "rollups" place no new assets into the partnership form. Since its rollup in 1981, Apache Petroleum Company (APC) has come back to the market several times to raise capital for oil and gas exploration and development, and APC has used its units as a financial currency to acquire oil and gas properties from Dow Chemical, Natomas and HNG.

"Rollouts"

In July 1983, Transco Energy Company contributed its domestic oil and gas assets and certain related liabilities into a partnership, Transco Exploration Partners, Ltd. which then sold an 11% minority interest to the public, effecting the first "rollout" of corporate assets into public partnership form (also referred to as a "dropdown" or transfer of assets). The proceeds from the offering were utilized to pay down debt that had been incurred previously for oil and gas exploration and development. The sale of partnership equity was anti-dilutive to Transco Energy's common shareowners contrasted to the sale of common stock (i.e., according to our calculations, Transco's earnings per share were improved slightly, contrasted to a visible and material reduction in earnings per share had Transco sold common stock to raise the same amount of funds). At that time, Transco would not have sold common stock, since its own equity market valuation (about \$750 million) was based upon a pipeline price/earnings multiple applied to its pipeline earnings with no apparent value given to the partnership's billion dollar oil and gas reserve position. Indeed, an outright sale of a minority interest in these oil and gas assets to a third party purchaser would not have produced the same value as the MLP. Therefore, the valuation produced by the partnership sale highlighted the value of these assets, allowed Transco to reduce its debt (leading to an improvement in its bond ratings), gave Transco a currency which it could use to enhance its dividend policy and served as a pricing mechanism for its very valuable oil and gas assets. Transco Energy, from time to time, had been subject to takeover rumors prior to the time these assets were placed in partnership form and independently valued in the marketplace; subsequently, partnership units were dividended to Transco shareholders to further enhance their return.

If you looked at the market values of the independent oil and gas companies, or, for that matter, some of the majors at the time of these offerings (1983-1985), you would have seen that market values for these companies' oil and gas reserves were well below the value that could be

generated through our MLP yield valuation model. Such explains much of the takeover activity in the oil and gas patch. The histories of El Paso, Northwest Pipeline, Texas Gas, HNG, Getty, Superior, Gulf, ANR, Phillips and Midcon all attest to this. As you know these forced consolidations resulted overall in the shrinking of United States exploration and development efforts in terms of both dollars and manpower.

Several other well known oil and gas companies and a few other natural resource concerns followed Transco's example with minority interest sales of partnership units to the public with the offering proceeds utilized to paydown partnership or sponsor debt. Such rollouts were accompanied by an acceleration of tax revenues through recapture taxes at inception and have increased the probability of increased sponsor income through reduced debt expense and lower levels of depreciable assets to the account of the corporate sponsor. In addition, since the sponsor, generally a corporate entity, has retained a significant interest (in excess of 50%), the corporate tax rate will be applied to its proportion of the partnership's results; on the other hand, the minority interest is generally sold to individuals, who are taxpayers, contrasted to the debt which was retired, which generally had been sold to large institutional investors who probably pay little or no taxes. So we think we have replaced debt with partnership equity and have added a new set of taxable investors and, therefore, have actually increased revenues to the Treasury.

With the decline in oil and gas prices we have seen no new oil and gas rollouts since early 1986. However, our recent nonresource rollouts generally have followed the same path: the sale of a minority interest to the public in MLP form because such sale produces the highest valuation for this particular set of assets and provides the lowest cost of equity financing available contrasted to the issuer's other alternative of raising equity capital through the sale of common stock; in addition, proceeds are generally used to pay down debt. However, in a number of our recent nonresource MLPs, reduction of overall corporate debt has been a corporate necessity. In these MLPs, generally the corporate sponsor needs to raise equity capital to reduce its debt. Sale of common stock was not a viable option because of the immediate dilution to the common shareholders (a corporate sale of common stock is the most expensive source of capital), and, in some extreme cases, as a result of the financial condition of the parent company, there was not a valid market for shares of the common stock to raise the same monies. Restructuring, or adding to, existing debt only serves to compound the financial problem of increased leverage at a time when it is not needed, and, as well, debt capital may not be available (I would remind you that a lender's willingness to lend is based ultimately on his views of a borrower's ability to raise common equity). Retention of earnings at the corporate level is another alternative that is always to be considered, if available. To be more precise - we have dealt with corporate sponsors of varying degrees of financial health. Those sponsors with other choices could leave debt on the balance sheet, could sell common stock or could retain rather than payout earnings; instead the MLP was utilized as a cost effective source of equity capital to meet corporate objectives of debt reduction and establishment of value for undervalued assets (an outright minority interest sale of these assets would not have produced the same value). However, some of our issuers did not have an attractive array of choices: they needed equity, they could not raise debt or sell common stock on financially acceptable terms - the asset they capitalized in MLP form was their best and only choice.

Analysis of most of our nonresource rollouts would illustrate that the corporate sponsor is selling a minority interest of a valued asset, a "crown jewel", and such sponsor retains control and has the predominant interest. Similar to our comments regarding the resource rollouts, we think these MLPs produce more positive revenue results to the Treasury than their corporate alternatives. We do recognize that there have been suggestions about the fixed amount of debt capital available, and that paying down debt just allows it to pop up somewhere else; however, all we see is a continuing growth in debt outstanding in the government, corporate and household sectors. Accordingly, we see the availability of this form of equity financing as an attractive financing alternative, without severe revenue implications to the Treasury.

Liquidations

The actual number of publicly traded companies converting to publicly traded partnership form has been relatively small but quite visible. Newhall Land and Farming Co.'s, Mesa Petroleum Co.'s and NVHomes' conversions in 1985 and 1986 were our three most visible examples until the passage of the Tax Reform Act of 1986. With the repeal of the General Utilities doctrine making it economically impractical to convert from publicly owned corporate form to partnership form after 1986, we saw a rush of conversions at year end 1986 since the new differential in individual and corporate tax rates suggested to these corporate issuers that now was time to escape the double tax burden of the corporate form; liquidation did mean reincorporation. Our records indicate that four attempts were made to convert but only three received the requisite shareholder approval. Community Psychiatric Centers failed to win the requisite shareholder approval for its plan to convert to a publicly traded limited partnership; in this case, institutional investors owned slightly over 50% of Community Psych's stock. We suspect that with the repeal of General Utilities doctrine, the imposition of a tax at both the corporate and shareholder level in the event of a conversion has eliminated, for all practical purposes, this form of MLP.

Acquisition MLPs

Our most recent versions of the MLP, which reflect an extension of our rollout MLPs, are the most difficult to understand from an outsider's point of view. These new MLPs have also been referred to as "equity buyouts", "asset sales", and "public buyouts"; and when we review some proposals by corporations to sell their unwanted asset, we refer to them as "exit" sales. To better describe these "acquisition MLPs", we think they can be divided into three groups (1) "public buyouts", (2) the "asset sale" and (3) the "blind (semi-blind) pool" MLP.

The public buyout (PBO) can be characterized as a public leveraged buyout capitalized with a $\pm 50\%$ debt ratio with debt sold to institutional investors in the private marketplace and equity ($\pm 50\%$ equity ratio) sold in the public marketplace primarily to individuals. The intent of the seller is to sell an operating entity (which generally has been a division or subsidiary of a publicly traded corporation) at the highest price available. This seller has looked at alternatives such as a third party sale to another corporation, a sale to the public in corporate form, an internal restructuring encumbering these assets with a significant level of debt, a leveraged buyout and our PBO. This general ordering of alternatives is intended to illustrate the increasing valuation and proceeds to the seller as he moves down the analytical path from third party sale...to the PBO. While the market has seen the surge in LBOs, again based on the pursuit of the highest dollar by the seller, only recently have sellers bypassed the LBO to utilize the PBO. As you know, characteristically, the leveraged buyout has been capitalized with a greater than 90% debt ratio, and, therefore, less than 10% equity, with both debt and equity sold in the private marketplace to "institutional" investors who are low or non-taxpayers. Some observations: with our PBOs, the initial sale provides at inception a higher taxable valuation than the seller's corporate alternatives and these MLPs will operate with lower levels of debt and with a greater dependence on a taxable investor group, the individual investor; accordingly, the revenue impact of eliminating this financing mechanism would probably result in the selection of alternatives designed to produce less revenues to the Treasury. In addition, from a practical point of view, given that this type of offering represents an "exit sale" with the desired objective of selling 100% of the equity to the public, we believe that without the availability of institutional investor backing, the number and size of possible transactions is limited. And, speaking of investment attributes, how many times have you seen a corporation voluntarily selling 100% of its "crown jewels"?

The asset sale represents the outright sale of a defined set of assets to the public (which may/may not be burdened with debt) in MLP form and, primarily, has consisted of sales of real property contrasted to utilization of its corporate counterpart, the REIT (real estate investment trust), another pass through vehicle. Generally the selection process involves consideration of the nature of the assets, optimizing current sale proceeds, the degree of operating flexibility the sponsor needs or desires, and the ability of the sponsor as GP

in MLP form to share in future results. What is the effect on Treasury revenues? This is harder to quantify: both entities pay out all free cash flow to owners. Consider that: (1) the REIT does not generate UBTI and therefore is owned by institutions and individuals (taxpayers and non-taxpayers); the MLP is owned primarily by individuals (taxpayers); (2) in MLP form, the more successful the results of the business entity, the more likely the GP receives a "backin" (or interest in profits) which ultimately is taxable at the sponsor's (corporate) tax rates; and (3) the flexibility of the MLP form suggests a better chance for growth. We think the market has yet to settle this debate, but it does not appear, currently, that we are dealing with a revenue loss/gain question but perhaps, instead, some opponents/proponents of MLPs/REITs are getting bogged down with insular positions. Our own position relates to raising the maximum amount of equity capital in the most efficient manner.

Our experience with a recent REIT offering would suggest to us that the REIT may be better suited for passive type real property investments, either on a diversified property or dedicated property basis, and that the real property MLP is better suited for operating assets that need to be actively managed as an ongoing business. In January, we lead managed a \$200 million offering for American Health Properties, Inc.; this is the third largest REIT offering completed in the eighties (1980-1987). We looked very carefully at the MLP/REIT equity alternatives. We advised American Medical International, Inc. (AMI) to proceed with a REIT offering because: (1) the assets of the proposed business entity were hospital facilities (dedicated properties) which were to be leased to AMI subsidiaries and, essentially, represented a passive property investment; (2) our objective was to maximize the issue size; to accomplish this objective, we needed institutional investors who we believed would be unavailable in sufficient size if the issue was structured in MLP form; and (3) while rentals based on gross revenues do not create UBTI in a partnership, utilization of debt to acquire properties would produce UBTI related to revenues derived from such properties and we knew the company intended to make additional investments in other health care-related facilities utilizing debt, as necessary. Accordingly, our decision was based upon the operational aspects of the properties, the intentions of management and the investment classification of the results (portfolio income vs. UBTI) in the hands of institutional investors.

The third new entry is the blind (semi-blind) pool MLP (some or all of the proposed partnership properties or securities holdings are not specified at inception). This structure is more typical of a real property or portfolio type partnership whose practical counterpart would be the REIT or mutual fund. With the exception of the remarks made above, we have not seen enough of these competing structures to have an opinion as to which structure is most manageable, marketable, or cost effective. In all cases, the intent is to raise capital. What are the tax effects? Unless the sponsors (actual issuer or syndicator) are touting their selection of the MLP form as providing passive income to offset passive loss from some new or old partnerships, I have a hard time posturing anything but revenue neutrality from Treasury's perspective. While we have not been active in either real property "asset sale" or "blind pool" MLPs, we have never "sought a trade", structured a deal, or sold a deal based upon the concept of passive income as defined under the new code...and we certainly will not given the possibility of a change in definitions in the future.

We would ask that you carefully consider the revenue implications of our public partnership offerings. We do not have revenue forecasts. We only can recount our experience with our issuers on a case by case basis. Since the MLP is so new a financing structure we would hope you would take the same approach, contrasted to a knee jerk reaction to anything bearing the name, MLP. We think our "rollups" and "rollouts" have, by and large, accelerated tax revenues through recapture taxes at inception and have increased sponsor taxable income through reduced debt expense and lower levels of depreciable assets at the sponsor level. On the other hand, our asset sales and PBOs generally have provided at inception a higher taxable valuation than their corporate counterparts, the REIT and leveraged buyout, and these PTPs will operate with lower levels of debt and with a greater dependence on a taxable investor group, the individual investor. Our point: the corporate alternative to these new MLP structures, by and large, probably would produce less revenues to the Treasury than these MLPs.

The 1986 Act and the MLP

Understanding who is the market, the construction of the partnership vehicle, and the uses to which the MLP is being put is necessary to reach any meaningful conclusions as to the effect of the Tax Act of 1986 on MLPs. The market is primarily retail and its requirement has been for current income which forces a partnership structure emphasizing full payout of cash with little or no value given to the potential for tax losses by our general individual investor group, particularly as a result of the 1986 Act. Such structure, to produce value, restricts the number of eligible targets to those with minimal capital expenditures and only those entities that can produce growth without capital expenditures have a chance of attracting institutional investors; nonetheless, institutionalized barriers such as the impact of UBTI on such institutions and the nuisance of filing state income tax reports will keep their participation low even were the MLP to meet their investment growth requirements. These MLP structures can not employ a heavy degree of leverage since any fluctuation in revenues has an immediate impact on per unit cash distributions. The market to date, which has not produced the best results to the buyers, is policing itself - i.e., you can not keep selling MLPs that trade down. MLPs are sold to produce value and we think their revenue implications are more positive to Treasury than their corporate counterparts. With this in mind, I would suggest that the Tax Reform Act of 1986 through its extension of the "at risk rules", the provision that passive income may only offset passive losses of other partnerships, and the repeal of the General Utilities doctrine, closing the "loophole" related to a corporate to partnership restructuring along with new partner reporting requirements have gone a long way to reduce any concerns of a mass exodus from corporate to partnership form and to the threat of increased revenue loss contrasted to what these issuers would have done without the MLP.

As you know, corporations employ a fairly heavy utilization of debt which, by and large, is sold to tax exempt institutions and such corporations practice an indefinite retention of corporate profits through low dividend payout policies in order to maintain their business endeavors and reduce taxation. Our MLP offerings generally have provided the highest achievable valuation for the business or assets being sold. The use of proceeds of our partnership offerings have been utilized primarily to pay down debt (whether it be partnership or the sponsor's debt) or pay top dollar value for the sale of designated assets, our MLP capital structures have been debt adverse (contrasted to what they would have been in corporate form - even our "public buyouts" are capitalized with less debt than their corporate cousins, the leveraged buyout) and, generally, full payout is made to investors who are taxpayers, that is, individuals.

Aside from tax revenue concerns we understand the Treasury's (IRS) concern for tax compliance on both the part of the partnership and its partners. Indeed tax compliance is more complex due to the need to comply with Partnership Taxation rules concerning the ultimate determination of tax liability, the need to breakdown overall consequences to the individual limited partner level, and the reporting necessary to allow the MLP to prepare K-1's for each of its unitholders. I think it is important to understand that when issuers, lawyers, accountants and bankers structure and offer publicly an MLP, we are operating in a "fish bowl". Our issuers are generally well known, and the lawyers, accountants and bankers are highly visible with reputations for expertise in this field. Our prospectuses are available for full public review; they contain the business description, the financial description, and the partnership agreements and reflect the conclusions of our legal and accounting experts on the application of partnership law and the tax code. Assumptions are made on the conservative side, and these experts are always available to discuss their views with the Treasury. These vehicles are not set up to take aggressive tax positions.

As a business entity, the MLP utilizes an organizational form that permits the results of operations, including tax benefits, if any, to flow through directly to the source of capital, that is, to the investor, whether that source be debt, preferred or "common unit"; any tax benefits that flow through to the investor merely reflect those incentives or other provisions that were legislated for the express purpose of fostering expansion and development

of that business endeavor regardless of business form. Our MLPs have been formed for valid business purposes. Access to a new set of investors for long term equity capital has provided more benefit to our issuers than any other equity alternative under consideration. In some cases, the MLP route represented the only practical source of capital (debt or equity). With the exception of corporate to partnership conversions, tax avoidance is not the driving force. In addition, we have not been involved in any transaction, and are unaware of any proposed transaction which was or will be precipitated as a result of the change in individual and corporate tax rates pursuant to the 1986 Act.

We do recognize that tax compliance is more complex due to the need to break down overall tax consequences to the individual limited partner level. However, many of the major Big-8 accounting firms have spent much time perfecting accounting software to break down items of income, loss, gain, deduction, and credit per individual partner. Their assumptions tend to be on the conservative side and while some problems remain, probably the biggest, "Street" name holdings, which sometimes has precluded preparation of totally personalized K-1s, will disappear as a function of legislation and our efforts. Specifically, major brokerage firms will comply with reporting requirements in order to get the names of the real holders of MLP units to the General Partners of these partnerships. Dean Witter can provide on a current basis names of the owners to MLPs but such a "data dump" is not really particularly useful without building a better history of the holder for the MLP. While the Treasury has not yet finally prescribed the exact information requirements and the form of such information, currently, our in-house programming staff is working with our operations people to write programs to provide more meaningful information for the MLPs. We are working under contract with Independent Election Corporation of America (IECA) who will act as collection agent interfacing with brokers, banks and other nominees nationwide to collect and consolidate the nominee information. IECA and Wall Street Concepts, (another independent consulting firm which had been conducting a pilot program at the request of the Technical Tax Committee of the Securities Industry Association in order to develop a "Street Names" Partners Report) announced on June 12 their agreement to jointly provide nominee services to the MLP community. Under the agreement Wall Street Concepts (WSC) will act as the servicing agent for the MLP issuers. WSC has proposed to provide MLPs with the Street Name Partners Report, a hard copy and tape service, which provides MLPs with nominee data in the format usable by their partnership unit accounting systems. IECA will act as collection agent interfacing with brokers, banks and other nominees nationwide to collect and consolidate the nominee information, and certify nominee compliance with section 6031. The point - we want to comply and we will.

Summary

Where does that leave us? As a result of structuring and selling PTPs to the public we would suggest that:

- (1) MLPs will be sold primarily to the individual investor as a high yield fixed income equity type investment with the primary emphasis on cash; the "market" is paying for current cash and not tax loss; and these MLP investments are intended as intermediate or long term investments and not as short term trading vehicles;
- (2) the MLP as an investment vehicle has widened an issuer's access to a broader investor group which previously could not participate in most partnerships as a result of high net worth and income requirements;
- (3) the valuation process and resulting MLP financial structure requires that the capital structures of MLPs will need to be more conservative (i.e., less debt) than their corporate counterparts and the cash payouts to owners well in excess of such counterparts;
- (4) the pricing and structure of the MLP suggest institutional interest will remain minimal, further restricting the

marketability for issues and the number and size of issues since loss of access to institutional equity serves as a major deterrent to a widespread use of MLPs;

- (5) the yield evaluation model is extremely efficient for those entities that fit but the implications of the valuation model suggest that there are not that many eligible candidates;
- (6) our MLPs have been formed for valid business purposes; access to a new set of investors for long term equity has afforded more economic benefits to our issuers than any other equity alternative under consideration, and, in some cases, the MLP equity route represented the only prudent or possible source of capital (debt or equity);
- (7) other than the rush of a few publicly traded corporations prior to year end 1986 to complete corporate to partnership conversions, thereby avoiding the implications of the repeal of the General Utilities doctrine, the use of the MLP has not been accelerated by the 1986 Act;
- (8) while partnership tax issues are complicated, our MLP issuers operate in full view of the public, utilizing accounting, tax, legal and banking experts, emphasizing full disclosure in their public documents (prospectuses, partnership agreements, quarterly and annual reports), and practicing conservatism when dealing with questions of partnership law and taxes;
- (9) Wall Street recognizes the added difficulty with regard to MLP tax reporting; we are working to cure this problem and will work to solve any other problem the Treasury or Internal Revenue Service may raise, and the MLP, as any new financing technique, may have wrinkles that need to be worked out but we will work them out;
- (10) in addition, while the Tax Reform Act of 1986 has shrunk the market of eligible candidates and has removed potential abuses, you can count on the fact that the marketplace, through daily price moves, will tend to wring out any other candidates unfit for the partnership form; with over 70% of our new issues trading below their initial offering prices, the marketplace can not continue to absorb MLP issues that trade down rather than up; and
- (11) for those concerned with revenue loss, the corporate alternatives to our recent MLP versions should be of greater concern to you than our MLPs; furthermore, without the availability of the MLP, prospective issuers may resort to additional debt, greater retention of earnings, or cancellation of projects rather than proceeding with a sale of their most costly equity security, common stock; consequently, we think our MLPs have been revenue effective, on balance, and have not eroded the Treasury's revenue base contrasted to the other alternatives available to these issuers.

Accordingly, we do believe, through the MLP, we are utilizing a cost effective equity vehicle which produces a higher value for the issuer's underlying assets than is currently available in the marketplace, and we are very concerned about attempts to destroy this financing mechanism. We are pleased to be able to address you today about our experience with MLPs and we would be pleased to spend as much time as you need to assist in a better understanding of our approach and our view on the appropriate use of this financing vehicle.

Chairman RANGEL. Thank you.
Mr. Nicoletti.

**STATEMENT OF WILLIAM P. NICOLETTI, SENIOR VICE
PRESIDENT, E.F. HUTTON & CO., INC.**

Mr. NICOLETTI. My name is Bill Nicoletti. I'm a senior vice president of E.F. Hutton with responsibility for Hutton's investment banking activities in both natural resources and master limited partnerships. Hutton has participated, as a managing underwriter, in a large number of publicly traded partnership offerings in the last few years, and I would like to offer you some insight based on those offerings and others we have studied on how and why MLP's raise capital and the implication of MLP rollouts on the Federal revenue base.

In the rollout form of an MLP, which is also known as a drop-down or a spinoff, an existing corporation transfers specific assets into an MLP and receives partnership units in return, which it then sells to the public, raising new funds.

The primary motive for rollouts is to raise capital on attractive terms. A rollout enables a corporation to raise money through the transfer of assets to an MLP while still retaining control of the assets.

It must be emphasized that issuing MLP interests, or units, through a rollout is a form of raising equity. Although a cash distribution rate is indicated to the public, there is no guarantee that such distributions will be paid indefinitely, and failure to pay is not an event of default.

In addition, unlike debt, MLP units do not mature and do not have to be repaid. Through an MLP the investor becomes a direct participant in the economic future of the MLP's business.

When assessing the revenue effect of a rollout, one should ask how the corporation would have raised that amount of capital if it had not used an MLP, and what the revenue effect of that alternative would be. In my experience, the alternative almost always would have been the use of debt financing.

In most of the major industries using MLP's today, the preference is for debt rather than equity financing. In the oil and gas industry, for example, in the last year and a half, eight times as much capital was raised through debt as through stock financing. In this industry, in particular, MLP's have been the only form of equity that the market would accept through much of the early 1980's. During that time the traditional equity market and the non-traded syndicated partnership market were basically closed out to most oil and gas companies.

Not only do MLP's avoid the growth of corporate debt, but they also use far less debt themselves than do corporations, and their investors are principally taxpaying individuals. Because rollouts have a corporate general partner, they continue to feed revenue into the corporate tax base through the income they pass through to their corporate sponsor.

Although MLP's can raise significant capital in certain industries, I do not anticipate that MLP's will become the favored form of conducting America's business.

For most businesses the disadvantage of the partnership form, compared to the corporate form, are simply too great. Perhaps the biggest disadvantage is the need for an MLP to distribute most of its cash flow to investors on a current basis rather than retain and reinvest it.

This is due to the fact that these investors have to pay tax on all partnership income, whether it's distributed or not, and that most MLP's are marketed on the basis of a high cash return to the investors.

In addition, another limiting factor regarding the MLP market has to do with the fact that its appeal is limited to certain segments of investors, primarily the individual seeking a high-yielding equity security. Hence, I believe that MLP's will continue to be used only in those businesses in which they represent the most attractive method of raising capital.

The point I want to emphasize is that MLP's are simply a new way of raising capital. Having worked with managers of dozens of businesses that have created MLP's, and many more that have considered but concluded that the MLP wasn't appropriate for them, I can tell you that they're not thinking much about double taxation, or the tax savings. They're simply thinking of how expensive or inexpensive it is to raise money through an MLP.

We've prepared an analysis of all new MLP offerings since the beginning of 1986, including some by existing MLP's. Altogether these 49 offerings raised \$3.8 billion in new capital. Of this we estimate that an excess of \$3 billion was used to repay debt, with the balance used primarily for capital expenditures and working capital.

So, as most of the people have indicated earlier today, it seems that the MLP's really probably generate tax revenue by reducing debt outstanding, rather than cost revenue for the Treasury.

In conclusion I want to say that with MLP's I think we have an innovative equity capital formation mechanism that is working, although on a limited basis. Not only does it not increase debt, it actually reduces it. And it does not require any special provision in the Tax Code. All that is required is for MLP's to be allowed to continue operating under current law.

Thank you.

[The prepared statement of Mr. Nicoletti follows:]

TESTIMONY OF WILLIAM P. NICOLETTI
SENIOR VICE PRESIDENT
E.F. HUTTON & COMPANY INC.
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

June 30, 1987

My name is William P. Nicoletti, and I am a Senior Vice President at E.F. Hutton in New York. E.F. Hutton has participated as co-managing underwriter in a large number of PTP offerings in the past few years, and I would like to offer you some insight, based on those offerings and others we have studied, on the questions of who is forming PTPs, why they are forming them, and the implications of their formation for the federal revenue base.

Who is Forming PTPs

PTPs are being formed predominantly in seven industries: 1) natural resources (primarily oil and gas); 2) real estate; 3) hotels and motels; 4) restaurants; 5) cable television; 6) entertainment (film production, sports teams, amusement parks, etc.); and 7) health care. Miscellaneous other industries in which one or more PTPs have been formed include investment management, equipment leasing, and equipment distribution.

Somewhere around 100 PTPs are currently known to exist. By far the largest number of these, well over a third, are in oil and gas; natural resources overall represent about 40% of the total. Real estate are the next largest group. In the 1986 and 1987, real estate has moved ahead of natural resources as the industry with the greatest use of PTPs.

Those PTPs in the other five major areas were mostly formed over the last two years. Each represents 3-5% of the overall total, and a larger percentage of the 1986-87 offerings. It may be worth noting that in two of these categories, hotels and restaurants, the primary asset in the partnership is real estate.

In a previous study undertaken by E.F. Hutton, we compared industries that raise capital through traditional non-traded partnerships to those industries using PTPs. It was no surprise to find that there is substantial overlap. The table in Appendix A shows that in 1986, when the real estate industry raised about \$1 billion through PTPs, seven times that was raised through non-traded partnerships. In fact, industries that make frequent use of PTPs have long histories of partnership financing.

How PTPs are Formed

Publicly traded limited partnerships have been formed primarily through three methods. In the "roll-up," several existing, non-traded limited partnerships are consolidated into one large publicly traded partnership. In the "roll-out" (also known as the "drop-down" or "spinoff"), an existing corporation transfers specific assets into a PTP and receives partnership units in return, which it either sells to the public, thereby raising new funds, or, less frequently, distributes to shareholders. Prior to the repeal of General Utilities, some corporations liquidated and converted into PTPs.

A survey of seventy-seven PTPs (two of which have since gone out of business) done earlier this year by the Coalition for Publicly Traded Partnerships found that a little over one-fifth had been formed through the roll-up method; about two-fifths were roll-outs and about one-sixth were liquidations. Each method of formation is motivated by different considerations.

Why PTPs Are Formed and the Revenue Implications

As I'm sure you have heard many times today, the repeal of General Utilities has made liquidations into PTPs unenconomic, and as a result, there is no reason to worry that ongoing American business is going to disincorporate for tax reasons.

Roll-ups are done in order to overcome two difficulties inherent in traditional non-traded partnerships. The first is illiquidity: investors in traditional partnerships often find it difficult to sell their interests at their fair market value. The second is that state and federal securities laws often restrict the marketing of non-traded partnerships to those investors who can invest in large amounts.

By rolling up into a PTP, partnerships can reach a new class of investors, one that is looking for an affordable and liquid investment with a high cash yield. In addition, combining several partnerships into one results in administrative efficiencies and economies of scale.

Obviously, since roll-ups transform one form of partnership interest into another, they aren't done to avoid corporate level tax. Just as obviously, they do not deprive the federal treasury of any corporate tax revenue, as none was being received in the first place. In fact, roll-ups are actually revenue enhancers, as they result in more frequent trading of partnership interests, producing capital gains recognition and, where applicable, recapture.

The primary motive for roll-outs is to raise additional capital on attractive terms. They enable corporations to raise money through a transfer of assets while retaining control of the assets. Roll-outs are often used to retire existing debt.

It must be emphasized that issuing PTP interests (or "Units") through a roll-out is raising equity. Although a distribution rate is indicated to the public, there is no guarantee that distributions will be paid indefinitely, and failure to pay is not an event of default. In addition, unlike debt, PTP Units do not mature and do not have to be repaid.

Roll-outs may also have the effect of segregating and highlighting undervalued assets so as to increase their market value. The value of a corporate sponsor's stock may also be enhanced by the increased dividend yield on the corporation's common stock if the corporation elects to dividend PTP units to its common shareholders. In addition, some roll-outs have the effect of helping to defend against hostile takeovers.

When assessing the revenue effect of a roll-out, you should ask how the corporation would have raised that amount of capital if it had not used a PTP, and what the revenue effect of that alternative would be. In my experience, the alternative almost always would have been the use of debt financing. If you look at the chart labeled Appendix B, you will see that in most of the major industries using PTPs today, the preference is for debt rather than equity financing. In the oil and gas industry, for example, eight times as much capital was raised through debt as through stock financing. In this industry, in particular, PTPs have been the only form of equity that the market would accept through much of the early 1980s. Remember as well, that already existing corporate debt is retired through PTPs, and that PTPs may be a substitute for a leveraged buyout.

*See Mary S. Lyman, An Overview of the Origin and Tax Treatment of Publicly Traded (Master) Limited Partnerships, 13 Tax Management of Washington Tax Review, 113-116.

As you know, corporate debt is costly to federal tax revenues. It generates interest deductions which often are not matched by taxable interest income, to the extent that the investors in corporate debt are tax-exempt institutions. PTPs avoid the growth of corporate debt; they use far less debt themselves than do corporations and their investors are principally taxpaying individuals.* And because roll-outs have a corporate general partner, they will continue to feed revenue into the corporate tax base through the income they pass through to their corporate sponsor.

Although PTPs can raise significant capital in certain industries, I do not anticipate that PTPs will become the favored form of conducting America's business. For most businesses, the disadvantages of the partnership form as compared to the corporate form are simply too great. Perhaps the biggest disadvantage is the need for a PTP to distribute most earnings to investors on a current basis, rather than retain and reinvest them, due to the fact that these investors pay tax on undistributed partnership income and that PTPs are marketed on the basis of a high cash yield. Other disadvantages, which I'm sure will be brought out in some of the other testimony you will hear today, are the lack of a perpetual existence, the lack of completely limited liability, the expense and complexity of forming and operating a large partnership, and the more settled and comprehensive state of corporate law.

In addition, PTPs appeal to a limited segment of investors, i.e., the individual seeking a high yielding equity security. Hence, I believe that PTPs will continue to be used only in those businesses in which they represent the most attractive method of raising capital.

PTPs Are Used for Capital Formation

The point I want to emphasize as strongly as possible is that PTPs are simply a new way of raising capital. Having worked with the managers of dozens of businesses that have created PTPs, I can tell you flatly that they are not thinking much about the double taxation aspect when they decide to take this step.

E.F. Hutton has prepared an analysis of all new PTP offerings (including some new offerings by existing PTPs) during 1986 through June 1987. These 49 offerings are summarized in the attached Appendix C. Altogether, these offerings raised \$3.8 billion in new capital. Of this, we estimate that in excess of \$3.0 billion was used to repay debt, with the balance used primarily for capital expenditures and working capital.

Conclusion

There is a tendency among policymakers in Congress and the executive branch to assume that people who do their financing through limited partnerships do so as a means of tax avoidance. There is also a tendency to be suspicious of a business entity that does not fit the traditional patterns or have statutory approval. The first reaction is to assume that some clever tax attorney has devised a new end run around the Internal Revenue Code. And if they find a few instances where that actually was the case, they generalize them to the entire population.

*PTP unitholders are not taxed on distributions to the extent that they represent a return of capital; however, they are taxed on their share of partnership income, whether or not it is actually distributed to them. Institutional shareholders of corporations, on the other hand, are principally untaxed on their dividend income.

I want to urge you in the strongest possible terms to avoid those reflex reactions when you look at publicly traded limited partnerships. The PTPs that are being formed today are being formed primarily because their sponsors need capital and believe that this is the capital formation mechanism that is best suited to the needs of their particular business. They are not intended to be a tax avoidance mechanism, nor is that the result of their formation. The increased economic activity that they generate may prove to be a revenue enhancer.

During the two years that you and your fellow committee members were working on tax reform, I heard a great deal of concern expressed about the need to encourage capital formation. I have also heard a great deal of concern expressed about the staggering amount of debt that is currently carried by the corporate sector. In PTPs you have an innovative equity capital formation mechanism that is working. Not only does it not increase debt, it actually reduces it. And it does not require any special provision in the tax code. All that is required is for PTPs to be allowed to continue operating under current law.

I urge you not to rush into precipitous action that would cut off this innovative method of capital formation. Take the time to study these entities carefully, and I think you will find that there is no need to change the status quo.

Appendix A

Industry Financings In 1986 & 1987 *

(\$ millions)

Industry	Common Stock	REIT Interests	Preferred Stock	Debt		MLP Units
				Investment Grade	Non-Inves. Grade	
OIL AND GAS	\$1,409.8 (a)	\$0.0	\$841.7	\$14,447.6	\$3,803.4	\$1,451
CABLE TV	0.0	0.0	0.0	0.0	1,400.0	178
RESTAURANTS	208.6	31.2	0.0	253.5	115.0	261
HOTELS	191.7	66.6	0.0	800.0	2,725.0	564
HEALTH CARE	136.0	779.4	0.0	2,131.8	596.0	120
HOMEBUILDERS	200.6	0.0	0.0	100.0	1,040.0	273
SHOPPING CENTERS	0.0	0.0	0.0	0.0	0.0	246
TOTALS	\$2,146.7	\$877.2	\$841.7	\$17,732.9	\$9,679.4	\$3,094

* Includes all offerings over \$10 million up to June 19, 1987.

(a) This includes a \$1.006 billion common stock offering by Occidental Petroleum in 1987.

Appendix B

Limited Partnerships
Total Capital Raised 1986

(\$ Billions)

	<u>Non-Traded</u>	<u>Traded PTPs</u>	<u>Total</u>
Real Estate	\$ 7.489	\$.972	\$ 8.461
Oil and Gas	.712	.514	1.226
Equipment Leasing	.717	.095	.812
Cable Systems	.243	.130	.378
Media/Film	.627	.060	.687
Miscellaneous	<u>.870</u>	<u>.764</u>	<u>1.634</u>
Total	<u>\$10.663</u>	<u>\$2.535</u>	<u>\$13.198</u>

Source: Robert A. Stanger & Co.

Appendix C
Analysis of Use of Proceeds of PTP Offerings

Date	Name	Net Proceeds (millions)		Use of Proceeds (millions)	
		Primary	Secondary	Debt Reduction	Cap. Ex./ Working Capital
1986					
01/14	Santa Fe Energy Partners, L.P.	\$91.0	---	\$91.0	---
02/20	Burger King Investors Master L.P.	---	\$72.1	72.1 ^a	---
05/12	The Vieta Organization Partnership, L.P.	\$3.9	---	---	\$3.9
06/04	UDC-Universal Development L.P.	19.8	4.9	19.8 4.9 ^a	---
08/05	Mauna Loa Macademia Partners	---	37.0	37.0 ^a	---
08/17	NV Homes	18.9	---	---	18.9
08/20	Fresport-McMullan Resource Partners L.P.	---	212.7	212.7 ^a	---
08/19	U.S. Realty Partners	27.8	---	---	27.8
09/20	EOK Green Acres, L.P.	81.9	---	81.9 ^a	---
09/19	Hess Limited Partnership	323.8	---	---	323.8
10/03	AirLease, Ltd.	58.2	---	58.2	---
10/09	Parkins Family Restaurants	59.7	---	53.0 ^a 6.7	---
10/15	LaQuinta Motor Inns	72.2	---	72.2 ^a	---
10/21	Angell Care Master	\$1.1	---	---	\$1.1
10/31	Hotel 6, L.P.	72.9	---	72.9	---
11/12	Commonwealth Mortgage of America, L.P.	---	120.6	120.6 ^a	---
11/20	Cal Fed Income Partners L.P.	101.8	---	101.8 ^a	---
11/20	Jones Intercable Investors, L.P.	41.6	---	41.6 ^a	---
12/04	Boston Celtics Limited Partnership	43.8	---	43.8 ^a	---

Date	Name	Net Proceeds (millions)		Use of Proceeds (millions)	
		Primary	Secondary	Debt Reduction	Cap. Ex./ Working Capital
1988					
12/11	Snyder Oil Partners, L.P.	17.2	---	1.8	15.3
12/16	Buckeye Partners, L.P.	221.5	---	221.5 ^a	---
12/17	Prime Motor Inns Limited Partnership	63.7	---	63.7 ^a	---
12/19	Forum Retirement Partners, L.P.	58.3	---	43.8 ^a 14.7	---
12/19	Vinchell's Donut Houses, L.P.	---	82.4	82.4 ^a	---
12/23	Equitable Real Estate Shopping Center L.P.	98.9	---	98.9 ^a	---
12/23	Falcon Cable Systems Company	72.0	---	58.5 13.5 ^a	---
1987 (a)					
01/15	Standard Pacific, L.P.	36.9	7.8	---	46.7
02/05	Sun Distributors L.P.	---	89.6	89.6	---
02/06	Emerald Homes L.P.	24.2	---	13.2 10.0 ^a	1.0
02/11	Interstate General Co. L.P.	15.3	---	12.8	2.7
02/27	De Laurentiis Film Partners L.P.	22.2	---	---	22.2
03/12	Galaxy Cablevision, L.P.	39.2	---	34.1 ^a	5.1
03/18	Family Group Broadcasting L.P.	8.7	---	---	8.7
03/18	Valero Natural Gas Partners L.P.	200.0	---	200.0 ^a	---
03/19	Petrolane Partners, L.P.	234.0	---	234.0 ^a	---
03/19	NAM Energy Co., L.P.	132.6	---	---	132.6
03/27	Allstar Inns, L.P.	66.4	---	66.4	---
04/07	Red Lion Inns Limited Partnership	---	98.8	98.8 ^a	---
04/08	Shopco Laurel Centre, L.P.	43.4	---	43.4 ^a	---
04/23	Cedar Fair, L.P.	147.0	---	135.5	11.5

Date	Name	Net Proceeds (millions)		Use of Proceeds (millions)	
		Primary	Secondary	Debt Reduction	Cap. Ex./ Working Capital
1987					
05/14	FFP Partners L.P.	21.0	---	18.5 ^a	4.5
05/15	Jones Interchange Investors L.P.	28.2	---	58.2 ^a	---
05/21	Reich & Tang L.P.	---	30.7	30.7 ^a	---
05/29	Freeport McMoan Resource Partners L.P.	117.4	---	17.4	---
06/03	Snyder Oil Partners L.P.	10.4	---	---	10.4
06/05	Permian Partners, L.P.	---	123.0	123.0 ^a	---
06/16	HV Homes L.P.	20.0	---	---	20.0
06/18	Fine Homes International L.P.	---	97.0	97.0 ^a	---
06/24	Prime Financial Partners, L.P.	<u>8.4</u>	<u>---</u>	<u>---</u>	<u>8.4</u>
	Total	<u>\$2,855.1</u>	<u>\$976.6</u>	<u>\$3,089.3</u>	<u>\$762.4</u>

^a Proceeds paid to affiliates, assumed used to pay down debt.

(a) Through June 28, 1987.

(b) \$40.2M will be used to pay a special distribution to cover unitholders' tax liabilities incurred upon conversion to partnership form. The rest will be used to pay down part of the Company's \$28M tax liability from conversion.

Chairman RANGEL. Thank you, Mr. Nicoletti.
Mr. Milburn.

**STATEMENT OF ROBERT D. MILBURN, PARTNER AND DIRECTOR,
REAL ESTATE INDUSTRY TAXATION, LAVENTHOL & HORWATH**

Mr. MILBURN. Thank you, Mr. Chairman. I appreciate this opportunity to present my views on master limited partnerships.

My name is Bob Milburn. I'm a partner with the national real estate accounting and consulting firm of Laventhol & Horwath.

I'd like to focus our attention on three areas: first of all, master partnerships are an efficient mechanism to raise capital for real estate investments; second, although it's been highly touted in some articles, real estate master limited partnerships are not an efficient means to use tax shelter losses created by other investments; last, I want to echo the comments of some of the others who have spoken today that we will not have wholesale disincorporation to form real estate master limited partnerships. The toll charge is just too high.

If I may, I'd like to focus on why the master limited partnership is particularly efficient means of raising capital. An earlier panel talked about "How big is the duck?" How big should the duck be? The answer is—as I think everybody here would agree—we're dealing with a bigger duck. These are larger enterprises that are raising capital, in general—especially for real estate investments—than we had in the past with the private placement.

One phenomenon of these investments is that each offering is larger, and the investment load, the cost of taking the offering to the street, is lower for a master limited partnership than it is for other types of passthrough real estate investments, such as the private placement that was so popular before the 1986 Tax Reform Act looked like it would become a reality.

I think the sale commissions have dropped from around 9 to 10 percent for private placements to between 4 and 7 percent, or lower, for master limited partnerships. That's the commission to the broker dealers. The overall cost of the offerings, under the old style of private placement, was about 25 percent of the equity raised, or 20 percent. Under the new regime of master partnerships, only 9 or 10 percent of the equity—or perhaps less—is taken by the people responsible for putting the deal together—from Wall Street, the lawyers, the accountants, and other advisors to the deal.

I think this is a very attractive feature in master partnerships, at least insofar as it raises capital for real estate. It's a different deal for the real estate investor. More people get to play now, and there is—when you have publicly traded partnerships, you also have the liquidity that makes it a realistic investment for the \$5,000 or \$10,000 a year investor.

To go on to my next topic: Master partnerships do not facilitate deduction of passive losses from other enterprises. If you have my handout you'll see on page 3 there's a table. Basically what it shows is a hypothetical investor who was asleep and didn't realize that the 1984 act and 1985 act were going to happen, so he bought a private placement partnership that required him to invest \$25,000 cash every year for 5 consecutive years. It was an old-style

tax shelter: for every \$25,000 you invest, you get \$50,000 of tax shelter on your k-1 every year. So this was the classical tax shelter before the 1984 and 1986 act.

You have no cash in the deal. If there are any residuals, it's been a good deal for you. But all of this has been eliminated; however, even though we've got the passive loss rules now, which if you look in the middle part of the page you see that the investor still has \$25,000 cash in the deal after tax because the passive rules have prevented him from getting tax benefits for the \$50,000 of tax loss in 1987 or 1988.

So the thought was: well, how about if somebody invests in a master limited partnership; it creates a lot of passive taxable income, and these otherwise worthless losses from other investments could be used to soak up the passive taxable income.

But the table at the bottom shows how much taxable income is needed to offset this \$50,000 a year. If it's fully taxable—and as Bob Stanger said earlier, these things are not fully taxable, they're 21 percent taxable or 20 percent taxable, on the average. I prepared a model for fully taxable, half-taxable, and one-third taxable. So let's say that on the third-taxable you have to have \$50,000 of passive taxable income, divide that by the third that's taxable. That means your pretax yield is \$150,000. Since these things show a 10 percent cash on cash yield because the marketplace demands it, the investor would have to put up \$1½ million in 1987 to create \$50,000 of passive taxable income.

As I indicate, what we really have here: the guy that got in in 1984 was a \$25,000 a year investor. Even if he can create the \$50,000 of taxable income by investing in a master partnership, he doesn't have the million and a half to invest any more than I do. So I think this is an area where, if the Congress doesn't choose to make passive income into portfolio income with respect to master partnerships, there's no harm done to the revenue. And as other speakers have suggested, if this is done, it will not be particularly harmful to investors or to the capital-raising marketplace.

I see that my time is up.

I'll be glad to answer other questions about disincorporation, but that's been very well covered by the other speakers.

Thank you.

[The prepared statement of Mr. Milburn follows:]

HEARING ON MASTER LIMITED PARTNERSHIPS
1100 LONGWORTH BUILDING
JUNE 30, 1987

SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

STATEMENT OF
ROBERT D. MILBURN
LAVENTHOL & HORWATH
WASHINGTON, D. C.

Chairman Rangel, I would like to thank you and the other members of the subcommittee for the opportunity to present my views concerning master limited partnerships. My name is Robert Milburn and I am a partner in the National Real Estate Accounting and Consulting Firm of Lavenothol & Horwath. My testimony today will cover the following three areas:

- Why MLPs are a fair and efficient mechanism to raise capital for real estate investments;
- Why real estate MLPs are not an efficient means to use tax shelter losses from other investments;
- Why corporations that disincorporate to form real estate master limited partnerships will not threaten the revenue, but will enhance revenue collections.

EFFICIENT MECHANISM TO RAISE CAPITAL

The real estate master limited partnership is a relatively new investment vehicle. Its popularity has expanded significantly since the first one was organized in 1981. This is because a real estate master limited partnership provides advantages to the small investor that are not available through partnerships that raise smaller amounts of capital and do not trade in a secondary securities market.

We can anticipate that the investment load on a private placement of real estate limited partnership securities will range between 20 and 25 percent, counting payments out of the offering proceeds to the selling broker/dealer, to the sponsor who puts the offering together, and to the lawyers, accountants, and other professional advisors who assist in getting the offering to market.

However, because of the relatively high amounts of capital raised by a master limited partnership, the load fees with respect to these offerings are much lower on a percentage basis. Broker-dealer sale commissions range between 4 and 7 percent, and total compensation to promoters, the advisors, and the broker-dealer as a whole will range between 9 and 10 percent -- and will sometimes be even lower.

It is the contrast between this 9 or 10 percent load in an offering of master limited partnership securities with the 20 to 25 percent load in a private placement of real estate securities to which I refer in saying that the master limited partnership gives the smaller investor the opportunity to invest in real estate he would not otherwise have.

Not only are MLP offerings subject to the greater regulatory scrutiny involved in a registered offering of securities, the larger volume of equity raised in each offering permits a lower load. Thus, a much greater proportion of an investor's total payment goes to the investment itself rather than to load fees.

In summary, the availability of widely-held limited partnerships as an investment vehicle makes it possible for the smaller investor - the \$5,000 to \$10,000 a year investor - to invest in real estate securities. The existence of a secondary market for these securities in the national stock exchanges (or over the counter) greatly enhances the suitability of such real estate investments for the smaller investor. It is important for these investors to have the liquidity that the secondary market in these securities supplies.

MLPs DO NOT FACILITATE
THE DEDUCTION OF PASSIVE LOSSES

I want to depart from the securities marketplace efficiency issue now, and look at an area I know is of concern to this committee. Treasury Department officials have suggested that investors will be able to use up their otherwise wasted passive losses from tax shelter investments by investing in master limited partnerships that produce corresponding amounts of otherwise taxable income. In almost all cases, this strategy will not really permit investors to use their passive losses.

The facing illustration shows a hypothetical tax shelter investment as it would have functioned before adoption of the 1986 Tax Act. Our hypothetical investor subscribed to a deal in 1984, promising to invest \$25,000 in each year through 1988. The offering materials for our hypothetical investment show tax losses of \$50,000 per year which the investor could have used to shelter income from other sources -- such as salary or profits of an active business. If an investor originally intending to shelter \$50,000 of salary with his passive losses takes no further action in 1987 and 1988, other than to make his \$25,000 annual payments, use of the investment to shelter his salary in 1987 would be totally frustrated by the 1986 Act.

However, it has been suggested by both commentators and Treasury Department officials that investors finding themselves in these circumstances will invest in master limited partnerships that generate corresponding amounts of taxable income, and that such investors may thereby circumvent the policy of the 1986 Act. This contention, without further examination, may suggest that such potential end runs around the passive loss rules should be harshly dealt with.

However, an investor who has signed up to pay \$25,000 a year to create \$50,000 of passive losses still will have approximately the same earnings capacity and level of net worth that he had before the 1986 Act was passed. The point of my comment on the hypothetical investor's net worth is this....this taxpayer is a \$25,000 a year investor. Let's examine what investment this taxpayer would have to make in a master limited partnership in order to shelter the \$50,000 of passive losses for which he is obliged to pay his \$25,000 each year.

Most master limited partnerships offer investors a 10 percent cash-on-cash return. Accordingly, as shown in the attached exhibit, for an investor to create \$50,000 of taxable income - assuming the cash flow is fully taxable - he would have to make a 1987 investment of \$500,000 in master limited partnership interests.

However, part of the cash flow from any real estate limited partnership will be sheltered. For example, if the cash flow from the investor's real estate MLPs is only 50 percent taxable, then the investor would instead need to have invested \$1 million in MLPs in order to have created \$100,000 of cash flow - only one-half of which would be taxable. If, as is common for start-up MLP investments, the yield is only one-third taxable, then we would have a situation where the investor would have to buy \$1-1/2 million worth of MLPs in 1987 in order to use up the \$50,000 of passive tax losses.

- 3 -

- HYPOTHETICAL SHELTER INVESTOR

- INVESTS IN A REAL ESTATE TAX SHELTER IN 1984

	1984	1985	1986	1987	1987
INVESTED CASH REQUIRED	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
FORECASTED TAX LOSS	(\$50,000)	(\$50,000)	(\$50,000)	(\$50,000)	(\$50,000)
CASH IN THE DEAL AFTER TAX (TOP BRACKET)	\$0	\$0	\$0	*	*

* IF PASSIVE LOSS RULES HAD NOT BEEN ENACTED.

- PASSAGE OF '86 TAX REFORM ACT
- ASSUME TAXPAYER HAS NO PASSIVE INCOME

Laventhol & Horwath
Certified Public Accountants

	1984	1985	1986	1987	1988
INVESTED CASH REQUIRED	\$25,000	\$25,000	\$25,000	\$25,000	\$25,000
FORECASTED TAX LOSS	(\$50,000)	(\$50,000)	(\$50,000)	(\$50,000)	(\$50,000)
CASH IN THE DEAL AFTER TAX (TOP BRACKET)	\$0	\$0	\$0	**	**

** IGNORES PHASE-IN RELIEF

National Tax Department
1101 Seventeenth Street N.W.
Washington, D.C. 20036
(202) 463-0700

Robert D. Milburn
Director
Real Estate Tax Services

- TAXPAYER WANTS TO INVEST X DOLLARS TO GENERATE ENOUGH PASSIVE INCOME TO UTILIZE THE POST-1986 LOSSES FROM THE 1984 INVESTMENT

IF THE YIELD IS —

	FULLY TAXABLE	1/2 TAXABLE	1/3 TAXABLE
PASSIVE TAXABLE INCOME NEEDED	\$50,000	\$50,000	\$50,000
DIVIDED BY % TAXABLE	100%	50%	33%
PRE-TAX CASH YIELD	\$50,000	\$100,000	\$150,000
DIVIDED BY % YIELD	10%	10%	10%
1987 INVESTMENT REQUIRED	\$500,000	\$1,000,000	\$1,500,000

Thus, the potential for using passive losses from other sources is severely restricted, because of the massive amounts of capital an investor must invest in master limited partnerships in order to achieve enough "shelterable" passive MLP income. Accordingly, I believe there is no significant revenue to be lost from other activities if the Congress continues the treatment of master limited partnerships as partnerships for tax purposes.

DISINCORPORATION IS NO THREAT TO THE REVENUE

As a final matter, it is appropriate to emphasize that disincorporation of activities to form real estate master limited partnerships does not threaten the revenue otherwise to be collected from those activities. An article that appeared in Forbes Magazine last year suggested that there would be a wholesale disincorporation of formerly incorporated American businesses. For a number of reasons, there will not be wholesale disincorporation of American businesses, and in general, to the extent there is such disincorporation, it will not threaten the revenue, but rather, it is likely to be revenue-positive.

As far as the number of disincorporations is concerned, the committee will want to consider that disincorporation and transition to master limited partnership status is not suitable for businesses that must reinvest their earnings in the growth of the business. Such businesses could not compete as MLPs because of the relatively high 10 percent cash-on-cash yields that must be offered in the marketplace for MLPs to attract investors. For these reasons, MLPs generally make sense only for start-up businesses only if they will have a relatively short interval between "day one" and the existence of the enterprise as a mature business.

What about avoiding this start-up period problem by disincorporating each business as it becomes "mature"? The 1986 Act repeal of the so-called General Utilities doctrine makes it unlikely that most mature corporate businesses will disincorporate. This is because of the 34 percent corporate level tax that would be imposed on the liquidating corporation on the excess of the fair market value of the corporate assets over their tax basis to the corporation. Additionally, a stockholder would be obliged to pay a 28 percent tax on the liquidation if the stockholder's share of the value of the corporate assets is more than he paid for his stock.

Because a C corporation is likely to be able to use losses of one business against the profits of a dissimilar activity, it is much more likely that a business operating as a master partnership will pay income tax than it would if it were incorporated.

Even if a corporation can avoid the General Utilities tax upon its liquidation because it has operating loss carryovers (NOLs), it could not avoid the stockholder tax. Since cash would not generally be disbursed to the stockholders in such a liquidation, they would have to pay their tax from other resources. Furthermore, any unused corporate NOLs would be lost forever, and the subsequent profits of the business, now in MLP form, would become immediately taxable to the entity's owners.

Let's assume for the moment that my discussion has demonstrated that disincorporation of existing businesses is not a genuine threat to the revenue. What about the possibility of organizing start-up businesses as master limited partnerships? In most cases, such an approach does not threaten the revenue; instead it provides added opportunities for the Treasury to collect revenue.

For example, if the new MLP is to raise capital from investors and then purchase the assets of an operating business -- or purchase currently operating mature real estate, the seller of these assets to the MLP will pay a tax on the purchase proceeds received from the MLP. The new installment sale rules and the expansion of the at-risk rules make it very unattractive,

- 5 -

respectively, for the seller or the MLP investors, if the seller finances the MLP's purchase, instead of selling for all cash.

In many cases, it will not make sense to organize a start-up business that will construct and operate rental real estate as a master limited partnership. This is because there will be no yield from the activity during the start-up period and, thus, it will be at a severe disadvantage against other MLPs which offer a 10 percent cash-on-cash yield from already operating properties.

As a final point concerning the organization of new ventures as master limited partnerships, there are many investors who will buy interests in these real estate master limited partnerships who would never have bought tax shelter partnership investments. As to these investors, because they are investing in something that directly taxes the profits of the business to the owners, they will owe an immediate tax on the profits of the enterprise. If they had bought stock in an otherwise identical corporate business, they would only owe tax themselves if the entity actually distributed the profits to them in cash.

I appreciate this opportunity to state my views on master limited partnerships, and I respectfully encourage this subcommittee to recommend that no change be made in the way these entities are treated for Federal income tax purposes.

Chairman RANGEL. Thank you, Mr. Milburn.
Mr. Robinson.

**STATEMENT OF GEORGE J. ROBINSON, PARTNER, PEAT
MARWICK MAIN & CO.**

Mr. ROBINSON. Thank you, Mr. Chairman.

My name is George Robinson. I'm a tax partner with Peat Marwick Main & Co. I'm here today to represent my firm, and the firm's MLP clients. Our clients represent a number of industries, including: oil and gas exploration and development, real estate investments, restaurant and hotel activities, and timber.

The growth of the MLP popularity has raised concerns about the complexity of the administration and tax compliance of MLP's. These concerns appear to be primarily based on the newness of the administrative concepts, although it's interesting to note that the issues associated with the administration in the reporting of tradable partnerships are not significantly complex. MLP tax reporting systems have been developed, and have been refined over the past seven years.

Some of the unique administrative and tax compliance considerations that must be addressed by the MLP's include the trading level of activity for MLP's. The MLP tax reporting systems monitor the trading through interaction and interfacing with the transfer agent's records, which identify who the partners are in the MLP.

As pointed out before by Jim Lovett, prior to 1987 there was significant problems with the lack of identification of the street name partners. However, with the enactment of section 6031(c) last year in the Tax Reform Act of 1986, those individuals will be identified in 1987 and future years. Action has already been taken to interface the existing tax reporting systems with a clearinghouse that is set up to actually interface between the brokers and the MLP's.

In the early 1980's when the MLP's were formed, one of the biggest issues that was addressed was the administrative complexities related to the section 754 election; however, those issues have been simplified dramatically. As pointed out earlier by Mark Kulier, where issues ever had to be concerned, the accounting firms would always make a decision with their clients that was very conservative, such that, if anything, taxpayers would have been slightly overstating any income.

I would like to emphasize that Federal income tax reporting has been a significant item for MLP's. They have taken considerable efforts, spent considerable sums of money on these systems and on their annual activities in providing the proper information to their partners. They put packages together that contain very detailed instructions to make sure that the partners are properly reporting the income. Plus they have systems that are in place to allocate partnership items to the partners as defined in the partnership agreement.

Part of the complexities with the systems has been through the changes that have come about through the years with the various tax legislation. As pointed out by Mr. Lovett earlier, the need for regulations under 704(c) is critical; otherwise it is not possible to

properly handle and address some of the problems that are brought out through tax legislation.

In conclusion, I just want to identify and emphasize that although the opponents of MLP's view the use of the MLP as administrative burden; the administrative problems have been mitigated by the use of sophisticated computer systems and applications. MLP's have successfully reduced the administrative burden, and will continue to improve their systems, procedures and controls.

Thank you.

[The prepared statement of Mr. Robinson follows:]

STATEMENT

OF

GEORGE J. ROBINSON, C.P.A.

PEAT MARWICK MAIN & CO.

1601 Elm St., Suite 1400

Dallas, Texas 75201

(214) 754-2112

before

THE HOUSE WAYS AND MEANS SUBCOMMITTEE

on

SELECT REVENUE MEASURES

My name is George Robinson. I am a partner with the Dallas office of Peat Marwick Main & Co. I am testifying on behalf of my firm and several of our clients which do business in the form of Master Limited Partnerships ("MLPs"). Our clients represent a select range of industries in which MLPs are commonly formed including oil & gas exploration and development, real estate investments, restaurant & hotel activities and timber.

My statement is organized and presented in the following manner. First, I will briefly respond to the concern that the MLP form of doing business will disincorporate the United States business community. Second, I will discuss in some detail the availability of computer systems capable of handling the administration, accounting and Federal tax reporting of MLPs.

I. Disincorporating the U.S. Form of Doing Business:

Concern has been expressed that the United States form of doing business will become disincorporated if MLPs (also referred to as publicly traded partnerships) are treated as partnerships for Federal income tax purposes. This concern has been increased in light of the lowering of individual tax rates below corporate tax rates as enacted by the Tax Reform Act of 1986. It is viewed by some that the combination of lowering of individual tax rates and the pass-thru nature of partnerships is a major incentive for corporations to change their form of doing business to that of a MLP. Furthermore, it is argued that the widespread shifting from the corporate to the partnership form of doing business, would result in a substantial loss of Federal income tax revenues. For the following reasons this interpretation of the U.S. business reaction to the changes in the Federal income tax rates and the resulting significant loss of tax revenue is difficult to accept.

A MLP is basically a tool used to raise capital and like any capital formation tool, its unique characteristics benefit only certain businesses. Businesses which have under valued assets, such as oil & gas reserves, form MLPs in order to highlight the true value of the assets and thereby raise additional capital. Another unique characteristic of businesses forming MLPs are those whose assets are somewhat liquid, such as oil and gas reserves and real estate, which provide adequate consideration for debt obligations in the case of dissolution.

Other businesses generally do not form MLPs as a result of the major distinctions between the corporate form and the partnership form. These distinctions include limited liability and limited life. Unlike a

shareholder, the general partner in a partnership is fully liable for the debts and obligations of the partnership. Therefore, partnership losses due to failure and debt obligations are not limited to the partnership's assets. Thus, only industries having assets undervalued will bare the risk of forming an MLP.

In addition, all limited partnerships have a limited life which can pose a liquidity problem upon dissolution. Although liquidity of assets may not appear to be a disincentive to forming a limited partnership at the beginning of its life, it becomes extremely important near the end of the partnership's life. Since most industries generally plan for longevity of income and cash flow, formation of an MLP is not acceptable by many. Furthermore, unlike corporations, which can be liquidated only by consent of the shareholders, a partnership is dissolved at the death, bankruptcy, or liquidation of its general partner. Although partnership agreements have been structured to avoid such a liquidation, most corporations if they conducted their business as a MLP do not have assets that can be easily liquidated or have a sufficient value to offset their obligations in the event of dissolution.

Regardless of the aforementioned reasons for non-disincorporation of the U.S. business community, it can also be stated that even with the growth of MLP popularity, only 100 or so businesses have formed MLPs since their inception seven years ago. Therefore, it is reasonable to conclude that disincorporation is not the U.S. business community's reaction to the enactment of the Tax Reform Act of 1986; rather, only a relatively small segment of the business community will conduct their business in the form of a MLP.

II. Availability of Accounting Systems for MLPs

Not only has the growth of the MLP popularity raised concerns regarding disincorporation, but also concerns about the complexity of administration and tax compliance of MLPs.

These concerns appear to be primarily based on the "newness" of the administrative concepts. It is interesting to note that the issues associated with the administration and the reporting of tradable partnerships are not significantly complex.

Partnership accounting systems have been developed and refined over the last 15 years. The fact that interests are publicly traded added several new dimensions to such systems, none of which posed impossible constraints. Some of the unique administrative and tax compliance considerations which are addressed by MLPs are as follows.

1. Monitoring the initial exchange and transfer of interest - The use of exchange and transfer agents have allowed individuals to exchange various interests in assets for tradable partnership units. The partnership accounting systems were enhanced to accommodate the interface required between partnership systems and the transfer and exchange agents systems. The normal ownership of partnership interests were expanded in a manner similar to functions normally carried out by a bank transfer department. The new ownership systems have the capability to perform all the necessary administration functions of the MLP. These functions include the ability to record partner ownership changes and maintain partner unit balance, certificates of ownership, issuance of cash distributions and recording all relevant statistical, tax, and financial data relating to the transfer of ownership interest. Since MLPs are currently maintaining the same data as the transfer/exchange agent, the monitoring of the partnership transfers is not a major administrative issue.

2. Section 754 Elections - Section 754 of the Internal Revenue Code of 1986 provides for an to be election made by a partnership which generally has the effect of increasing or decreasing the basis of the partnership assets with respect to a partnership interest which has been purchased from another partner. This adjustment in basis reflects the price paid by the purchasing partner for such interest. By agreeing to make the Section 754 election, an accounting for the amortization of any basis adjustment to each purchasing partner is required. Additionally, the partnership is responsible for reporting to the transferor partner any recapture of depreciation arising by reason of a subsequent transfer of the partnership interest. The administrative problems created by the Section 754 elections are not substantial since the current MLPs that have made a Section 754 election have computer systems in place to calculate and report the necessary information required. This information is determined by using the transfer agent data coupled with the use of general partner confirmation activities. Furthermore, the majority of these systems have been designed so that flexibility exists to be adapted for future regulatory changes in these calculations.
3. Federal Income Tax Treatment and Election - Certain tax treatments and elections are determined or made at the partnership level. These elections and treatments are fully disclosed in the prospectus and reported to the partners in accordance with the partnership agreement. Special tax treatment attributable to individual partners is handled using data acquired from confirmations, transfer agents, and selected defaults. The use of historical tax data and information provides a starting point for the special tax treatment required by Section 704(c) of the Internal Revenue Code of 1986 for the assets which have been contributed to the partnership. With the use of partner classes, the partnership tax reporting systems have been able to maintain and report the separate tax treatment for each partner and retain the appropriate audit trail.
4. Federal Income Tax Reporting - The tax reporting requirements for MLPs are the standard partnership return Form 1065 and Schedules K-1. With the advent of laser printers, the only administrative inconvenience is the reporting to partners whose partnership interest is held by a nominee. However, a firm is already acting as a clearinghouse in collecting and coupling with the MLPs tax reporting systems, the information required by Section 6031 of the Internal Revenue Code of 1986 for partnership interests held by a nominee. This service will virtually eliminate the administrative inconveniences of reporting tax information to partners whose partnership interest is held by a nominee. In addition, the partnership systems historically addressed this problem by providing facsimile Schedules K-1 prepared from confirmations or by generating a "One Unit" workbook for investors whose partnership interest is held by a nominee. This methodology of "One Unit" reporting is common in tradable trusts. The one unit workbook allows the individual to calculate the information required for their personal return.
5. Partnership Termination - Section 708(b) of the Internal Revenue Code of 1986 provides that a partnership shall terminate if 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a twelve month period. If such were to happen, the partnership technically terminates with respect to all partners and would immediately be reconstructed by the remaining partners. While

generally few adverse tax consequences would be associated with the termination and reconstitution of the partnership, the filing of a partnership return would be required for the short period ending on the date of the technical termination of the partnership. The MLP tax reporting systems monitor the change in ownership of the partnership as reported by the transfer agent to determine if a technical termination occurred.

6. Sale or Exchange of Partnership Interest by a Partner - When a participant sells the interest in the partnership, the partnership's taxable year will terminate as to such participant on the date of the sale. If a partner has claimed tax benefits for the interest in the partnership, these benefits may be subject to recapture if the partner sells all or a part of the partnership interest. The MLP tax reporting systems provide such information for the computation of gain or loss on disposition of units.

Opponents of MLPs view the use of the MLP as an administrative burden. However, such administrative problems have been mitigated by the use of sophisticated computers and computer applications. MLP's have successfully reduced the administrative burden and will continue to improve the systems, procedures and controls.

Summary

In conclusion, Peat Marwick Main & Co. and its MLP clients believe that the present tax treatment of partnerships whose interest are publicly traded should not be changed. The disincorporation of the United States is not occurring. Furthermore, the belief that MLPs are not complying with the Federal income tax reporting requirements is not correct as sophisticated computer systems are properly reporting the information required.

Chairman RANGEL. Thank you, Mr. Robinson.

REPORTER. Excuse me, Mr. Chairman. Is your mike on?

Chairman RANGEL. It's on now.

I didn't recall the administration indicating that the administration of the MLP's was the major problem. Do all of you get that reading, that the reason they asked us to review this is because they can't handle it administratively?

Mr. OELSNER. Mr. Chairman, I think that was one of the three items specifically cited. It was referred to in Mr. Mentz' testimony, talking about Treasury's considerations of administrative complexity, competitive fairness, and the ultimate integrity of the corporate income tax base. It was one of the same arguments that was raised by Mr. Mentz on June 9, last year.

Chairman RANGEL. Well, obviously, I know your testimony emphasized that whatever had to be done, that you felt that the way to do it, I assume, is through regulation rather than legislation; is that correct?

Mr. OELSNER. Well, we have the—yes. We have the regulations, and Wall Street is working with two independent consulting firms to put together the tapes—of beneficial holder's names—to get the information to the MLP's on a timely basis.

Chairman RANGEL. Well, since you people are the practitioners in this, it would seem to me that if you feel the administration has a problem as it relates to the administrative compliance that you might want to share with the committee what your recommendations, specifically, would be to streamline the process. I have the clear impression that that wasn't what they had asked us to look at. One that they never dealt with is the question of creating equity capital, which certainly is a decision that the administration would have to face up to, that if they thought this was the proper vehicle rather than using high yield bonds. But, they had suggested to this committee that this form of partnership, for all practical purposes, was a corporate structure and should be taxed as such, and that it was bad tax policy to allow people to decide whether or not they want to avoid tax liability, corporate tax liability, and set up the MLP.

Obviously, you're saying that some people have said that the laws are so complex that there's no fear for erosion of the corporate tax structure in the future, as the Secretary has said.

So it would seem to me that it would be helpful if: one, you're not going to deal with the question of tax policy because all of you are in accord that you think it's sound tax policy; and, two, on the question of erosion of the corporate tax structure all of you speak in one voice that this raises revenue rather than loses revenue; then you might want to address the question of the administration of the MLP's, and I suspect that you might be the best people to do that.

Mr. OELSNER. Can I just approach that from a general point of view, which is that there are two concerns which I have heard. One is nominee reporting, and that Wall Street has not had the ability, or has not delivered to the MLP's, the names of the actual holders of the partnership units and has not presented the information that shows when they purchased the units, whether they still have them, or when they sold them.

That has been reflected to us as a compliance problem from the IRS's point of view. They are trying to ensure that a recipient of income of cash distribution appropriately records it.

The other problem has related to whether there could be a subsequent audit 1, 2, 3, or later, years down the road, and how could one—the IRS—justify the expense of going back to a multitude of partners to try to collect an adjustment. I will give you some general answers and perhaps my partners here can give some more specific answers.

No. 1, on June 12 of this year the two independent consulting firms, Wall Street Concepts and Independent Election Corp. of America, announced their agreement to work together, and our back office people are working to put together the appropriate tapes to actually provide all the requisite information to go to the general partner so that the IRS can see specifically who owns units, when they were purchased, what the price was, and when they were sold.

Then, ultimately, that part of the compliance is up to the IRS with this record, looking to see if the individual owner actually did what he was supposed to do.

Chairman RANGEL. When is all of this supposed to happen?

Mr. OELSNER. That is being worked on today, currently.

Chairman RANGEL. Well, why don't you just send what you think will solve the problem to the Commissioner of IRS, and send a copy of your communication to me?

Mr. OELSNER. Okay.

Chairman RANGEL. Don't you think that would make sense for you?

Mr. OELSNER. Yes. I mean, we are in the process of working out to fulfill the requirement of section 6031(c).

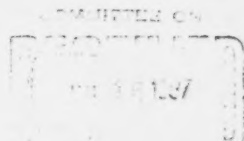
[The following was subsequently received:]

DEAN WITTER REYNOLDS INC.
#2 World Trade Center, New York, NY 10048 Telephone (212) 524-2222



July 15, 1987

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
2330 Rayburn House Office Building
Washington, D.C. 20515



Dear Chairman Rangel:

When I appeared before your Subcommittee on Select Revenue Measures on June 30, you questioned members of our panel about the concern of the Department of the Treasury ("Treasury") regarding MLP compliance issues and suggested that members of our panel work with the Treasury Department to arrive at possible solutions. I specifically noted Treasury's concern for tax collection issues posed by Master Limited Partnerships with attendant compliance and enforcement problems for the Internal Revenue Service (p. 15-16 J. Roger Mentz Testimony, June 30, 1987) and Treasury's suggestion that "enforcement and collection difficulties could be minimized by imposing a withholding tax on MLPs and collecting any tax deficiencies from the MLP (thereby forcing the current partners, rather than the partners in the year to which the deficiency relates, to bear the burden of the additional tax)."

I would like to respond to these points, but, first, I would agree with you that the MLP participants (issuers, accountants, lawyers, bankers, etc.) should work these details out with Treasury since they are not of such a magnitude as to distract the focus of your Committee from the more important issue of classification of MLPs. I can tell you I have seen no evidence of a failure by MLP investors to report income.

Nevertheless, the Internal Revenue Code of 1986 in Section 6031 (c) (1) Nominee Reporting prescribed procedures to be followed by nominees in order to ensure that MLPs will have the names of all beneficial owners so that the MLP can provide customized K-1s to all owners of MLP units and to Treasury (at present, this is done only indirectly such that individualized K-1s are not provided by all owners). This Section is intended to address the so-called "street name" holdings problem and allow the Internal Revenue Service (IRS) to confirm that actual owners are properly accounting for the results of their partnership interests. While Treasury has not yet finally prescribed the exact information requirements and the form of such information, currently, our in-house programming staff is working with our operations people to write programs to provide more meaningful information for the MLPs. We are working under contract with Independent Election Corporation of America (IECA) who will act as data collection agent interfacing with brokers, banks and other nominees nationwide to collect and consolidate the nominee

information, and certify nominee compliance with Section 6031. IECA and Wall Street Concepts, (another independent consulting firm which had been conducting a pilot program at the request of the Technical Tax Committee of the Securities Industry Association in order to develop a "Street Names" Partners Report) announced on June 12 their agreement to jointly provide nominee services to the MLP community. Under the agreement Wall Street Concepts (WSC) will act as the servicing agent for MLP issuers. WSC has proposed to provide MLPs with the Street Name Partners Report, a hard copy and tape service, which provides MLPs with nominee data in the format usable by their partnership unit accounting systems. As you can see, we intend to comply with the nominee reporting rules, and we expect the rest of Wall Street to follow suit.

Since the nominee reporting rules will allow Treasury to monitor and assure investor compliance, Treasury's suggestion that a withholding tax be imposed at the MLP level makes little sense. Furthermore, withholding taxes on one type of security and not all securities, while completely unfair, represents a quick means to (1) foreclose further issuance of that effected security in the marketplace and (2) reduce immediately and dramatically the market value of that security. The Eurobond market has provided a recent example of the results of an uninformed decision to effectively impose a withholding tax on certain fixed income securities (see attached Wall Street Journal articles). While the facts are different, the point is clear: Treasury did not do its homework (first, purchasers of these Eurobonds would not have purchased these bonds subject to withholding taxes; and, second, certain issuers are taking advantage of Treasury's actions by calling high coupon bonds pursuant to special redemption provisions related to the imposition of withholding taxes). This kind of action should not be repeated.

On the other hand, collection of tax deficiencies (related to audit adjustments of previous returns) at the MLP level is something we believe is a workable solution to a potential administrative problem associated with a collection of tax deficiencies.

We would be happy to work with Treasury to address any additional problems they raise and find satisfactory solutions. (A copy of this correspondence will be forwarded to Treasury.) As I noted in my testimony, the MLP is a relatively new financing technique and may have other wrinkles to be worked out, but we will work them out.

Respectfully yours,

Edward C. Oelsner, III

Edward C. Oelsner, III
Managing Director
Investment Banking

Enclosures

cc: The Honorable J. Roger Mentz
Mr. Robert J. Leonard

U.S. Move to End Antilles Tax Treaty Alarms Many Investors and Borrowers

THE WALL STREET JOURNAL

July 1, 1987

By MATTHEW WINKLER

Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—The Treasury's decision to terminate a 1964 tax treaty with the Netherlands Antilles sparked immediate alarm among large and small investors around the world as well as many large U.S. corporate borrowers.

Terminating the treaty confronts the U.S. borrowers with the prospect of higher tax charges. That, in turn, could hurt thousands of investors by forcing the borrowers to redeem as much as \$32 billion of U.S. corporate Eurobonds issued before 1984, according to data compiled by Salomon Brothers Inc. At the same time, it could seriously undermine foreign investor confidence in U.S. debt securities issued overseas, according to investors, analysts and corporate borrowers.

"This is going to cost us a fortune," said Hans-Joerg Rudloff, a general manager of Credit Suisse, Switzerland's third largest bank and one of the biggest investors in the Eurobond market. "You cannot be a sponsor of global markets as the U.S. has been and then change tax policy without sending an unbelievable shock through the financial system."

The tax policy change, which takes effect Jan. 1, already has caused havoc among investors in the \$650 billion Eurobond market. After the Treasury's announcement Monday, prices of hundreds of pre-1984 Eurobond issues by U.S. companies were marked down as much as 20 points, or \$200 for each \$1,000 face amount.

Eurobonds issued after the affected date have dropped only moderately in the past two sessions, but analysts warn of sharp declines if the treaty expires.

Tax Charges

Ending the tax treaty with the Netherlands Antilles likely would force dozens of U.S. companies to take a heavy tax charge on their debt issued through their Antilles subsidiaries. As a result, these companies are expected to retire such debt as quickly as they can, thereby alienating a major segment of their investor base.

"This is an historic date in the Euro-market," said a senior officer at Bank Julius Baer, Zurich, who fears a wave of Eurobond redemptions by U.S. companies and huge losses on the bank's holdings. "This could be the end of American companies borrowing in the Euro-market," he said.

Many U.S. companies doubt that will happen. Nonetheless, "There's no question that the Treasury's action will reduce the confidence individual European investors have in U.S. issuers," said Frederick W. Zuckerman, vice president and treasurer at Chrysler Corp. in Detroit. "You're going to see turmoil for a while and that will make it tough for U.S. companies to issue in the Eurobond market."

Jack Greenberg, executive vice president and chief financial officer at Oakbrook, Ill.-based McDonald's Corp., agreed. "I share foreign investors' reaction. The market needs stability. But from McDonald's perspective and many other U.S. companies, we have an obligation to

call higher-costing debt and replace it with lower-costing debt."

Messrs. Zuckerman and Greenberg remain confident the Eurobond market will continue to be a source of funds for U.S. concerns. "There's always a market for top-grade corporate paper," said the McDonald's executive. "Three or four months from now, things will settle down and this won't be as momentous as it now seems," said Chrysler's Mr. Zuckerman.

Domestic Focus

Whatever the case, U.S. corporations have arranged the bulk of their financing in the domestic market the past year, largely because foreigners were reluctant to purchase dollar-denominated securities while the currency was in a deep slump. "The fact is the U.S. market is so much deeper than any other capital market," said Mr. Greenberg.

Under the treaty, debt issued in the Netherlands Antilles was exempt from a U.S. tax law provision imposing a 30% withholding tax on interest paid to foreign bondholders by the U.S. government, its agencies and private corporations. As a result, most U.S. companies used the Antilles offshore financing vehicles to borrow abroad, a process that often provided substantial savings compared with the domestic market.

Repeal in 1984

In 1984, the 30% withholding tax was repealed, enabling foreigners to buy all U.S. debt securities on a tax-exempt basis and corporations to issue debt directly from the U.S. The tax legislation also removed a major barrier to the global capital market as foreign investors substantially increased their holdings of U.S. bonds.

But many U.S. companies maintained foreign subsidiaries in the Netherlands Antilles so they could continue servicing about \$32 billion of Eurobond debt issued offshore before mid-1984.

Most of these Eurobonds, which are marketed in anonymous bearer form, were sold under terms that allow them to be called in by the issuer at a price of par, or substantially below their current market value, said Edward D. Kleinbard, a tax partner at Cleary, Gottlieb, Steen & Hamilton. The difference in price would stem largely from the fact that long-term bond yields were as much as six percentage points higher than they are today.

The end of the treaty would make the parent companies' affiliates liable for a tax charge of at least 30% on its annual Eurobond interest payments, said Mr. Kleinbard. "That's why most U.S. companies will choose to call their bonds," he said.

That prospect worries investors on both sides of the Atlantic. "Bondholders are getting the short end of the stick once again," said Edward Labenaki Jr., a vice president and portfolio manager at Minneapolis-based IDS Advisory Group. IDS, like other U.S. individual and institutional investors, can purchase Eurobonds in the secondary market. "There's no question individual as well as institutional investors will have losses as a result of the likely redemptions," Mr. Labenaki said.

July 3, 1987

Treasury to Seek Rule Protecting Antilles Bonds

'We Screwed Up' in Ending Tax Treaty, Aide Says; Three Firms Call Issues

By ALAN MURRAY
And MATTHEW WINKLER
Staff Reporters of The Wall Street Journal

Stunned by the reaction to its termination of a tax treaty with the Netherlands Antilles, the Treasury Department announced that it will seek legislation to protect investors who own U.S. corporate bonds issued through the Caribbean island nation.

"We didn't anticipate the full market reaction" to terminating the treaty, said Roger Mentz, assistant Treasury secretary for tax policy. Another department official put it more bluntly: "We screwed up."

On Monday, the Treasury announced that it was terminating the tax treaty after negotiations with the Netherlands Antilles reached, in Mr. Mentz's words, "total log-jams." The announcement caused a segment of the Eurobond market to plummet, because it meant interest on some \$32 billion of U.S. corporate bonds issued through the island nation would become subject to 30% withholding for tax purposes.

Three U.S. companies have called in their affected Eurobond issues, and more are expected to follow despite the potential for lawsuits from bondholders.

Aides Weren't Consulted

Experts say the Eurobond market reaction should have been easy to anticipate. But the Treasury's market specialists apparently weren't involved in the decision to terminate the treaty, which was made by Treasury Secretary James Baker in consultation with Mr. Mentz and others from the office of tax policy.

Treasury Undersecretary George Gould, Assistant Secretary for Domestic Finance Charles Seltman and Assistant Secretary for International Affairs David Mulford—all of whom have extensive experience in domestic and foreign financial markets—weren't involved in the decision to terminate the treaty.

Treasury tax officials said they also were surprised to learn from investment banks that many of the Eurobonds issued through the Netherlands Antilles are held by U.S. residents—not by foreigners. The Treasury tax office had no information on the owners of the bonds, but other officials familiar with the Eurobond market say U.S. residents may hold from 15% to 30% of the bonds. While U.S. investors are prohibited from buying such bonds when the securities are offered, they can purchase them in the secondary market.

The termination of the tax treaty won't take effect for six months, and the Treasury has until then to persuade Congress to enact legislation sheltering the bond investors from tax-withholding. It isn't clear whether Congress will act on the measure.

In the meantime, the Treasury announcement may calm the Eurobond market somewhat. But some investors could still suffer as a result of the Treasury's termination of the tax treaty.

Before 1984, the Netherlands Antilles served as the conduit for U.S. companies wishing to issue bonds in the European market. The reason was that the tax treaty exempted bonds issued through U.S. subsidiaries there from a U.S. requirement that 30% of the interest paid on bonds issued overseas be withheld for tax purposes.

In 1984, Congress repealed the withholding tax for all new Eurobonds, but not for pre-existing bonds. But the termination of the tax treaty with the Netherlands Antilles will mean that bonds issued through the Caribbean island before June 22, 1984, will become subject to the withholding requirement.

Most of these bonds have provisions that allow the issuing companies to buy them back if withholding is ever imposed. Otherwise, under the terms of the bonds, the issuing companies would be required to pay the withholding tax.

Because interest rates were higher in the early 1980s than they are now, most of the companies involved would like to seize the opportunity to save money by calling in their high-interest Eurobonds. But if they do, investors will face large losses.

Some companies and investors are calling on the Treasury to retreat altogether from its plans to terminate the Netherlands Antilles tax treaty. But Mr. Mentz said that course is neither possible nor desirable.

Two companies—RJR Nabisco Inc. and Caterpillar Inc.—called in their bonds yesterday before the latest Treasury announcement. But bond lawyers said other companies may be discouraged from calling in the bonds in the wake of the Treasury announcement, fearing they would face lawsuits from domestic and foreign bondholders.

"It's now going to be very difficult for a law firm to give an opinion that a call is appropriate in light of the Treasury's announcement," said Scott A. Levine, a senior vice president at Morgan Guaranty Trust Co. in New York. "The Treasury's announcement is so explicit and unequivocal."

'Dampening Effect'

John Corry, a tax partner at Davis Polk & Wardwell, said the Treasury's move "will have a significant dampening effect on issuers' decision to call these bonds. From a legal point of view," he added, "it's estimated that about 40% of the \$32 billion of Eurobonds issued from the Antilles can be called only after all reasonable efforts to avoid withholding tax have been exhausted."

Nevertheless, at least one U.S. company, Bank of Boston Corp., decided after the Treasury's announcement yesterday to call its bonds. The bank said late yesterday afternoon that it will call \$100 million of 14½% notes due 1990.

Edward D. Kleinbard, a tax partner at Cleary, Gottlieb, Steen & Hamilton, said, "The difficult legal question is whether is-

suers have some implied duty of good faith to bondholders to avoid calling the bonds if they can avoid the tax. This will be wonderful for our litigation practice."

Some institutional investors said even RJR Nabisco and Caterpillar will face strong protests and possible suits from bondholders.

"Many large U.S. investors, for example, purchased high-yielding, zero-coupon Eurobonds for pension funds, charitable endowments and profit-sharing plans on a very reasonable assumption they wouldn't be called," said Luke Knecht, vice president in charge of institutional investment at Harris Trust & Savings Bank, Chicago.

"That income can't be replaced easily now with interest rates so much lower today than they were" several years ago, he said. He said U.S. investors purchased "about 25%" of the U.S. corporate Eurobonds issued from the Antilles and that they face the prospect of getting about \$750 million less on their investments if their bonds are called. "I promise you a lot of bondholders will challenge these calls," Mr. Knecht said.

Both Caterpillar and RJR Nabisco stand to gain windfalls from redeeming expensive debt issued back in 1982 and refinancing at rates several percentage points lower.

At Caterpillar, officials said they still are calling in \$400 million of bonds initially yielding more than 14% in spite of yesterday's Treasury announcement. And officials at RJR Nabisco said the announcement "won't affect our decision to call \$400 million" of zero-coupon Eurobonds, which also had an initial yield of more than 14%.

"Certainly we care about the bondholders, but you have to look at all the factors," said a spokeswoman for RJR Nabisco.

Outraged Reaction From U.S. Investors Is Behind Treasury Reversal on Antilles

CREDIT MARKETS

By MATTHEW WORKLER

Staff Reporter of The Wall Street Journal

NEW YORK—The Eurobond market, which seemed relatively obscure to some senior Treasury officials just two weeks ago, emerged at the center of a government policy mess that roiled large and small investors from Newport Beach, Calif., to Cambridge, Mass.

"It became a nightmare," said a Treasury tax specialist. "We had no idea there would be reverberations throughout the credit markets," he said. "We know better now."

Late Friday, after the New York and London markets closed, the Treasury moved to calm investors. It modified its plan to terminate a 30-year-old tax treaty with the Netherlands Antilles so that interest payments linked to Eurobonds issued by U.S. corporate affiliates through the island group would be exempt from a 30% withholding tax.

Foreign investors were the first to complain of severe bond losses after the Treasury said June 28 it would terminate its tax treaty with the Netherlands Antilles. But U.S. investors, who may turn out to be among the biggest holders of Eurobonds issued by U.S. companies overseas, were equally incensed. And, that's ultimately what prompted the Treasury to back down.

Unilateral termination of the treaty would have been "very damaging to a wide array of U.S. investment institutions," said Radford Rigby, a portfolio manager at Cambridge-based Harvard Management Co. "It was just the opposite of a windfall gain. Many individual retirement accounts and profit-sharing plans would have been hurt."

Segment Phrased

The Treasury's announcement caused a segment of the Eurobond market to plummet because it meant most U.S. companies that issued an estimated \$32 billion of Eurobonds from Antilles affiliates before mid-1984 immediately could call in their bonds, according to lawyers familiar with the bonds' indentures.

Some issuers, including RJR Nabisco Inc. and J.C. Penney Co., already have called about \$1.4 billion face amount of Eurobonds as a result of the June 28 Treasury announcement. Most of these bonds were issued with effective yields exceeding 14%, or several percentage points above today's similar-maturing Eurobond offerings.

The calls represented "an immediate economic loss to the bondholders of about \$120 million," said Rene Jaquet, vice chairman of the Zurich, Switzerland-based

Association of International Bond Dealers, in a letter to Treasury Secretary James Baker last Thursday. The long-term impact would have been more severe on U.S. concerns' ability to borrow abroad and would have "substantially reduced the level of confidence prevailing in the international securities markets," he said.

Since 1965, U.S. corporations have issued an average of more than \$3 billion of international bonds a month, according to data compiled by Salomon Brothers Inc. The biggest issuers of Eurodollar bonds in recent years include subsidiaries or affiliates of General Electric Co., General Motors Acceptance Corp., Citicorp and Ford Motor Co.

"The Treasury's first announcement on the treaty made a joke of the capital markets," said Richard Clout, vice president, borrowing, at Detroit-based GMAC. "It was absurd."

Protest Meeting

Officials of American International Group, a large New York-based insurer, personally protested to Treasury officials in a Washington meeting last Wednesday. "We hold about \$1 billion of Eurobonds and have an exposure of about \$120 million" on Eurobonds facing immediate calls, said a representative for the company. "Obviously, it was serious for us."

At Pacific Mutual Life Insurance Co., which holds about \$200 million of Eurobonds, "we face the prospect of an entire fixed-income fund being wiped out," said Larry J. Card, vice president of fixed-income securities at the Newport Beach-based insurer. "Our Eurobond holdings are invested in the full gamut of our products, from guaranteed investment contracts to whole and universal life insurance policies."

Alan M. Cobb, president and chief executive officer at Providence, R.I.-based Barclay Investments Inc., said the Treasury's unilateral termination of the Antilles tax treaty threatened "to wipe out millions of dollars invested by very large college endowments and insurance companies, the two groups of customers we specifically know use the Eurobond market."

J. Roger Mehta, assistant secretary for tax policy, initially thought most of the furor was confined to Europe and said he wasn't that concerned until he learned otherwise. But that comment only added fuel to the fire. "It appears that the U.S. Treasury continues to act with disdain for the non-U.S. investor," said Mr. Jaquet of the international bond dealers group.

In his letter to Secretary Baker, he scolded the Treasury for implying that "it was acceptable to provoke arbitrary and massive losses in bond portfolios held by Europeans, but that corrective action has had to be taken because it turned out that substantial losses would be suffered by American investors."

Yield Spreads

Apparently unbeknownst to some at the Treasury, the Eurobond market began capitulating U.S. investors more than five years ago, when yields on U.S. corporate Eurodollar bonds occasionally were as much as 1.15 percentage points above yields on similar-maturing domestic corporate bonds, according to Giola M. Parente, an international bond analyst at Salomon Brothers.

The sharp difference in yield between the U.S. and Eurodollar markets often occurs during periods when foreign investors consider the dollar a weak currency or when a glut of new offerings drives down prices before the offerings are all sold.

Although most U.S. investors can't under U.S. law buy new Eurobond issues, they can purchase Eurobonds in the secondary market after they're considered "seasoned." Pacific Mutual's Mr. Card, for example, said, "We frequently have acquired Eurodollar bonds at prices that gave us a yield pick-up" of about 0.25 percentage point "over the identical corporate bond in the U.S."

Edward D. Kleinbard, a tax partner at Cleary, Gottlieb, Steen & Hamilton, said: "It's comforting that the Treasury now has demonstrated so much sensitivity to the disruption it caused to the capital markets. It's a pity that the Treasury had to precipitate the market reaction in order to reach the right result in the end."

THE WALL STREET JOURNAL

July 13, 1987

Mr. OELSNER. The second area that was raised was the concern if there were to be an audit somewhere down the line, for the ability of the IRS to get back to the owners to recoup taxes that they might believe payable. We have—our own point of view, and I'll let the panel present their point of view—our view is that there ought to be provision made in the partnership agreement such that certain payments could be made directly by the partnership at the time of the audit, to be paid, essentially, by the partners at that time.

Chairman RANGEL. Mr. Nicoletti?

Mr. NICOLETTI. Yes, sir.

Chairman RANGEL. Were you trying to get my attention?

Mr. NICOLETTI. No, sir.

Chairman RANGEL. I'm sorry.

Mr. LOVETT. Mr. Chairman, on the compliance issue, I think the Assistant Secretary, this time a year ago, placed much more emphasis in his comments on the compliance concerns the Treasury possessed. His comments today were much broader in terms of the erosion of the corporate tax base. And while he mentioned compliance issues, he passed over that very lightly.

Our comments are intended to ensure this subcommittee that compliance is more than feasible. Our clients oftentimes look at the master limited partnership as a source of financing, and the cost associated with that compliance effort oftentimes will make them choose other forms of financing. There is a significant cost associated with doing business as a publicly traded partnership; however, assuming that nominee reporting is effectively implemented—and I say "assuming" because, as you may be aware, there is no penalty associated for the nominee's failure to comply with 6031(c), although I understand technical corrections may include a penalty in the future—but assuming that those systems are successfully implemented, and we have no reason to believe at this time that they will not be, nominee reporting is a very significant step in assuring compliance with the partnership rules and regulations.

Chairman RANGEL. Well, I want you to know that certainly your testimony is going to weigh heavily on what the subcommittee decides to do as relates to recommendations to the full committee, and I hope that your respective firms might hold yourselves open for further questions that members who could not attend today's hearings may have after they review your testimony.

I want to thank you, on behalf of the full committee, for taking time out to share your views with us.

The committee stands adjourned until tomorrow morning, 10 o'clock.

[Whereupon, at 3:54 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Wednesday, July 1, 1987.]

MASTER LIMITED PARTNERSHIPS

WEDNESDAY, JULY, 1, 1987

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. The Select Revenue Subcommittee will come to order.

I want to welcome everyone back this morning. Today we continue the subcommittee's hearing on the issue of the master limited partnerships.

Yesterday we heard testimony from Treasury strongly advocating that most MLPs be classified as corporations for Federal income tax purposes.

The other witnesses testified on both sides of this tax policy issue, and we were a little disappointed that there was no money to be raised in the short run to get to the \$19.3 billion goal.

We had some thoughtful recommendations as to why the legislation should be retained, some indicating at least until we complete the subchapter C studies, but it is a complex issue, and the committee is not rushing into it until we have the benefit of discussion with witnesses that have significant experience in this area.

The Chair now recognizes Mr. Flipppo for any opening statement he may wish to make.

Mr. FLIPPO. I just want to thank the chairman for continuing these hearings on this very important matter and we appreciate our witnesses' testimony today.

Chairman RANGEL. Mr. Brown?

Mr. BROWN. No remarks.

Chairman RANGEL. This first panel, the ENSERCH Corp., Goldman, Sachs & Co., Merrill Lynch & Co., our old and dear friend, John Chapoton is counsel, the former Assistant Secretary of Treasury for Tax Policy; and he is accompanied by Mr. Ballentine of Peat Marwick Main & Co., former Associate Director for Economic Policy of OMB, and former Deputy Assistant Secretary of the Treasury for Tax Analysis.

From Apache Corp., we have Mr. Edwin Cain, who is vice president in charge of Government relations; and from the Sun Co., we have John Neafsey, who is the executive vice president and chief financial officer.

John Lollar is here, president and chief operating officer of the Transco Energy Co., and he runs the Transco Exploration Partners.

Mr. Andrews, do you have any statement to make before the witnesses start?

Mr. ANDREWS. No, Mr. Chairman.

Chairman RANGEL. We hope the witnesses will try to deal closely with the theme of tax policy. The issue is whether the question of complexity can be dealt with perhaps by regulation.

The question of revenue is a long-term thing that fortunately for those who are advocating that we do nothing, that we will not be driven to do something because of the deficit, because the money won't be there in the short run, so we would have time to look at it. But for some of us who believe it looks like a corporation, it does everything else a corporation does except pay taxes.

This is an area this Member needs help in and you might share your experiences with us.

We will start with Mr. Chapoton.

STATEMENT OF JOHN E. CHAPOTON, COUNSEL, ON BEHALF OF ENSERCH CORP., GOLDMAN, SACHS & CO., MERRILL LYNCH & CO., INC., AND FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, ACCOMPANIED BY J. GREGORY BALLENTINE, PRINCIPAL, PEAT MARWICK MAIN & CO., AND FORMER ASSOCIATE DIRECTOR FOR ECONOMIC POLICY, OFFICE OF MANAGEMENT AND BUDGET, AND FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX ANALYSIS

Mr. CHAPOTON. Thank you, Mr. Chairman.

I am John Chapoton. I am appearing on behalf of ENSERCH Corp., Merrill Lynch, and Goldman, Sachs, and am accompanied by Greg Ballentine who is a principal of Peat Marwick.

I am going to focus my remarks solely on the tax policy issues presented by MLPs.

The double tax system applied to income of corporations clearly distorts financial decisions to the detriment of us all. It causes corporations to be overleveraged—to issue debt rather than equity—increasing vulnerability to insolvency and bankruptcy.

It discourages distribution of corporate earnings—thus separating the value of corporate stock from the income it produces for its owner, and providing a rationale for management to retain profits whether or not justified by performance.

The double tax on corporate earnings is a poor system of taxation, and it should not be expanded by applying it to MLPs unless other policy considerations outweigh the undesirable effects of an expansion of the double tax system.

Two reasons are commonly given for wanting to expand the corporate tax to MLPs:

One, it is necessary to prevent erosion of the corporate tax base.

Two, it is necessary to prevent competitive inequality among taxpayers.

In my view, neither of these concerns are valid. Thus, I do not think that the expansion of the double tax system to MLPs can be justified.

Let me first address the fear of erosion of the double tax base.

Concern has been expressed about erosion of the corporate tax base from the growth in MLPs. The first thing to understand is that the existing corporate tax base is protected from erosion—it is locked into the double tax.

The 1986 act repeal of *General Utilities*, and the taxation on gain on corporate stock at the same rate as dividends, locked in the double tax on corporate income generated by the existing corporate tax base.

And the existing corporate tax base is huge—\$2.4 trillion in 1986.

Thus, the only legitimate concern is the impact of MLPs on growth in the corporate tax base—and reduced growth can only occur from new capital raised by MLPs that would otherwise be raised by corporations, and even then only to the extent that MLP investment substitutes for investment that would otherwise have been financed by issuance of new corporate shares.

The tax treatment of corporate investment financed by debt and by retained earnings is essentially single-taxed—like investment financed by MLPs—and thus the overwhelming dollar volume of corporate investment is today financed by debt and retained earnings.

To repeat—to the extent MLP financing is substituted for debt financing or retained earning financing, there is little or no revenue loss.

Relatively little corporate financing is done by corporations issuing new stock—undoubtedly for the simple reason that income from corporate investment financed with issues of stock is double taxed—taxwise, it is the most expensive form of financing.

Only 8 percent of all corporate investment from 1950 to 1983 was financed with new stock issues.

Over the last 10 years, an average of only about 24 of the Fortune 500 companies have issued new common stock in any given year.

And, to repeat, it is only to the extent that the growth of MLPs substitutes for investment that would otherwise have been financed by new issues of corporate stock that a reduced growth in the corporate tax base can possibly result from MLPs.

Thus, in my view, there obviously will be no hemorrhage of Federal revenues. Even under Treasury's estimate, if you do nothing, the total effect on Federal revenues in 1990, for example, from applying the double tax to MLPs will be a reduction of approximately 0.00053 of 1 percent of total revenues from the corporate income tax.

I would hardly call that a hemorrhage.

Finally, let me address this pure tax policy issue: Will taxing MLPs as corporations help or harm the neutrality of the tax system?

I have already stated it would be harmful from a neutrality standpoint.

U.S. capital markets are highly integrated; those seeking funds for new investment—whether or not in the corporate sector—must compete for funding with all other investments in the U.S. economy. To the extent this tax treatment is different, there is an uneven playing field.

As my written statement shows, most capital investment in the U.S. bears the lower cost of capital attributable to a single tax—or no tax—owner-occupied housing, for example.

Mr. Ballentine's study of net investment in the United States from 1950 to 1985 shows that only 3 percent of total investment is double taxed.

Even excluding noncorporate investment and considering only investment made by corporations, he shows that only 8 percent of investment by corporations is double taxed—that is the share of corporate investment that was financed by issuance of new corporate shares.

Thus, it clearly cannot be a move in the direction of increasing neutrality to increase, however slightly, the small portion of investment that is financed at the double tax cost of new corporate shares.

The neutrality issue is sometimes phrased as if corporations and MLPs are the only relevant taxpayers. This ignores the fact that there are many other single-taxed entities that compete in the capital market with corporations and MLPs.

From any perspective, it is undesirable for the tax system to advantage one financing alternative over another. However, until the Congress decides to apply the double tax to all U.S. investment, including sole proprietorships and debt financing, or is willing to eliminate the double tax on all new corporate investment, some tax disparity cannot be eliminated; it will exist wherever the line is drawn.

So the issue before this subcommittee is whether moving the line to expand double taxation worsens or improves overall tax equity.

The figures clearly show single taxation is the norm, and reducing the investment that is taxed as the norm—by expanding the double tax to MLPs—would worsen competitive equity.

In conclusion, let me state that I have trouble with the suggestion that MLPs are a private, backdoor method of integration not approved by Congress.

MLPs are clearly partnerships and under present law they are taxed as partnerships. Partnership taxation has been sanctioned by Congress since the beginning of the income tax.

There is no particular logic in selecting publicly traded partnerships for the double tax. It is true that large publicly held partnerships have many similarities to publicly held corporations, but medium-sized partnerships have similarities to medium-sized corporations, and small partnerships have similarities to closely held corporations.

Small- and medium-sized ventures often select the partnership form of doing business for tax and other reasons.

There is no conceptual basis on which to deny the partnership route to large publicly held ventures. Indeed that is the only way small investors could enjoy direct investment and direct taxation.

Thank you, Mr. Chairman.

[The statement of Mr. Chapoton follows:]

STATEMENT OF
JOHN E. CHAPOTON
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
July 1, 1987

My name is John E. Chapoton. I am a partner in the Washington office of the law firm of Vinson & Elkins. I appear today representing Merrill Lynch & Co., Goldman, Sachs & Co., and ENSERCH Corporation. I am accompanied by J. Gregory Ballentine, a principal in the Washington office of Peat Marwick Main & Co. 1/

I am going to focus my remarks on the basic tax policy issues presented by so-called Master Limited Partnerships (MLPs). In my view much of the public debate has been misdirected. Taxing MLPs as corporations can only be justified if doing so is necessary

- (a) To protect federal revenues from an erosion of the corporate double tax; or
- (b) To prevent competitive inequality among taxpayers. 2/

These considerations do not support corporate taxation of MLPs. I conclude that MLPs will not lead to an erosion of the existing corporate tax base and that any diversion of new investment from the corporate sector into MLPs will have little revenue effect. Moreover, taxing MLPs as corporations would harm, not help, the competitive equality of our tax system.

MLPs Are a Financing Option

At the outset let me explain what Master Limited Partnerships are and why they are utilized.

A Master Limited Partnership is a limited partnership organized under state law. (Usually there are two limited partnerships, one "master" partnership that is owned primarily by the public, and a second-tier partnership that is the operating entity and is owned primarily by the MLP.) Limited partnership interests, usually called "units", may be readily bought and sold in the open market and are typically listed on public exchanges.

Under present tax law, MLPs are treated like other partnerships. The MLP computes its taxable income and files an information return with the IRS. The partnership itself pays no tax; rather, each partner pays tax on that partner's proportionate share of the partnership's taxable income, whether or not the MLP actually distributes any income to the partners. There is no avoidance or deferral of tax by the partners. Because there is no separate tax imposed at the partnership level, we refer to partnership income as being single-taxed.

1/ The economic analysis contained in this statement is based on a paper prepared by Mr. Ballentine which examines the impact on tax neutrality of taxing MLPs as corporations.

2/ I do not in this statement discuss administrative concerns with MLPs; I do not believe such concerns will or should be a determinative factor in deciding the basic question of how these entities should be taxed. To the extent administrative issues exist, they should be considered and dealt with separately.

There is nothing unusual about MLPs -- they look and act like other large partnerships -- except the fact that interests in MLPs can be bought and sold more readily than interests in other partnerships.

MLPs are utilized almost exclusively as a technique for raising new capital from the public. Tax considerations are important -- they are important in any business financing arrangement -- but there is no diabolic tax avoidance scheme involved, as some seem to imply. In many cases, MLPs have been formed from pre-existing partnerships in industries that have traditionally operated in partnership form. In others, they are one of several financing options available to corporations.

The chief financial officer ("CFO") of a corporation has a range of options for raising new capital from the public: issuance of stock (common or preferred), issuance of debt, use of retained earnings, or creation of an MLP. The tax consequences to the corporation vary according to the option selected.

In most cases, the CFO will rule out the use of new corporate stock. Investments financed by new stock issues incur a double tax. Not surprisingly, new stock issues have been a very small and infrequent source of finance for corporations (only 8% of corporate investment from 1950 to 1983 was financed by new stock issues, and over the last 10 years on average only about 24 out of the Fortune 500 corporations have issued new common stock in any given year).

As described below, investments financed by debt, retained earnings, and an MLP are all essentially single-taxed. Thus this tax consideration is irrelevant to the CFO's choice among these three options. This will surprise many of you and thus bears restating -- when, as is very often the case, every alternative being considered for raising new capital is single taxed, the MLP route offers no tax benefit in this regard as compared to the other financing options on the table. In such a case other considerations will determine whether an MLP is utilized.

There are numerous non-tax reasons for using MLPs. Most common is the desire to avoid additional debt, but there are other considerations as well. For example, several energy corporations utilized MLPs to establish the market value of their oil and gas reserves and thus raise the value of their stock, while also raising capital for development of their reserves. The tax benefits offered by an MLP play little, if any, role in such decisions.

There are also non-tax consequences of MLPs that will not be welcome to the managers of the venture. Primary among these will be the practical necessity of paying out a much larger portion of the earnings of the venture than would be necessary if the corporate vehicle had been selected. The unitholders in an MLP will have paid tax on their share of the earnings of the venture, whether or not distributed, and thus can be expected to insist that significant portions of the income on which they have paid tax be distributed to them. The managers will have to be much more clear about their plans for any retained earnings than would be the case in the corporate context.

Presumably influenced by these factors, MLPs tend to trade in the financial markets at values based on their distributed earnings -- that is, their cash flow -- and are generally regarded as not being suitable vehicles for growth where large amounts of earnings must be plowed back into the business.

Another adverse factor is that the pool of potential investors for MLP units is restricted. Pension funds and other tax exempt organizations do not find most MLPs attractive because they would have to report their share of the MLP's income as unrelated business taxable income; mutual funds find that MLP income is not "qualifying income" for purposes of maintaining their regulated investment company status; foreigners find they must report their share of MLP income as though

they were engaged in the MLP's U.S. business; and potential corporate investors find they give up the 80% dividends received deduction if they invest in MLP units rather than corporate stock.

Thus while discussion of MLPs (particularly in this room) usually focuses on the tax consequences of MLPs and alternative financing options, in a great many instances the tax treatment of all the options is essentially the same. In such cases, the non-tax consequences of an MLP -- some favorable and some unfavorable -- will dictate whether the MLP is utilized.

With this background, I would like to review the policy issues involved in expanding the corporate double tax to these types of partnerships.

"Real World" Reasons for Disliking the Double Tax

Tax policy specialists traditionally have argued that all income should be taxed, but only once. Our corporate tax system imposes a double tax on the income from some new corporate investment. The preponderance of economists and tax policy experts argue that such a double tax is an extra levy on certain investment and thus tilts the tax system away from savings and toward consumption. Moreover, it is unclear who actually bears the burden of the corporate level tax -- consumers (through higher prices), labor (through lower wages), shareholders (through reduced dividends), or some combination of all three.

While the incidence of the double tax and its effect on savings and investment are controversial and difficult to verify, we can readily see undesirable effects of the double tax on corporate behavior: (i) it contributes to excessive leveraging of corporate assets by causing corporations to issue debt to raise capital when common or preferred stock would otherwise be more prudent; and (ii) it discourages distribution of corporate earnings by imposing a tax on dividends paid, a tax which may easily be postponed by withholding the corporate earnings from their true owners, the shareholders, and using the earnings as the corporate managers see fit.

If we were designing an income tax on a clean slate, surely we would not intentionally bias corporate finance in favor of debt, with the attendant increased risks of bankruptcy. Furthermore, we would not use the tax system to give corporate managers a rationale for controlling and reinvesting corporate earnings without regard to their investment performance by imposing an immediate tax penalty on earnings that they do not retain.

We would instead design a system of taxing corporate earnings that collects the levy fully and immediately, but is as neutral as possible on such important decisions as whether to increase leverage of corporate assets or whether to distribute or retain earnings. Such a tax system would cause the value of corporate stock to be more closely related to the income it produces.

These are real-world problems caused by the double tax on corporate income. They cannot be solved today because the revenue loss from forgiving the double tax on earnings of today's huge corporate equity base is simply too great. ^{3/} Just as important, to do so would confer a windfall benefit on owners of existing corporate shares who made their investment decisions based upon the double tax burden.

^{3/} At the end of 1986, the value of equity interests held by individuals in U.S. corporations was \$2.4 trillion.

However, the inability to solve these problems with respect to existing corporate equity provides no justification for extending these rules, with their undesirable consequences, to situations to which they do not now apply. Proponents of doing so seem to assume, often without careful analysis, that failure to tax every investment that "quacks like a duck" -- i.e., is similar in appearance to a corporation -- will either erode the corporate tax base unacceptably, or will render the corporate tax unfair by permitting some ventures in effect to elect pass-through taxation while other ventures remain subject to the corporate tax.

Impact of MLPs on the Corporate Tax Base

Alarmists suggest that the continued existence of MLPs will seriously erode the corporate double tax base in short order. ^{4/} This concern has been greatly overstated.

The first thing to understand when considering the potential impact of MLPs on the corporate tax base is that the exceedingly large existing tax base is protected from such erosion -- it is effectively locked into a double tax.

The repeal of the General Utilities doctrine and the elimination of the preferential treatment of capital gains combine to assure a full double tax on corporate investment by imposing a corporate level tax on all appreciation of existing corporate assets and by taxing shareholder gain as ordinary income. Even if one assumed corporations might decide to liquidate and reorganize as MLPs (using the equity remaining after tax), there is no avoidance of the double tax on the existing corporate base. The liquidation would simply result in an acceleration of the corporate and shareholder taxes, producing an immediate tax that is equivalent in present value terms to the future taxes that would have been collected had the liquidated assets remained in corporate solution.

Because the existing corporate base is not subject to erosion by MLPs, the only potential adverse revenue effect from MLPs is on the growth in revenues from the double tax base, and that effect could arise only with respect to the new capital raised by MLPs that would otherwise be raised by corporations.

However, only a small portion of the new investment made by MLPs could result in any loss of revenues from the corporate double-tax system. Real estate ventures, for example, have traditionally operated as partnerships. If MLPs are taxed as corporations, new real estate ventures undoubtedly will utilize other partnership forms. With respect to the supposed erosion issue, this means that much MLP investment will simply "erode" other forms of single-taxed partnership investment, thereby not having any tax effect.

^{4/} Expanding corporate classification rules would result automatically in the classification of owners' income from newly classified "corporate" entities as portfolio income for purposes of the passive loss rules of section 469. Reclassifying, as portfolio income, certain sources of passive income against which passive losses might otherwise be deductible will produce an immediate tax revenue increase to the federal government. However, the issue of an entity's income classification for purposes of the passive loss rules is clearly severable from the issue of the entity's organizational classification for tax purposes, and can be decided outside the context of the organizational classification debate. Given the severability of the two issues, it is not appropriate to characterize revenue attributable to the income classification issue as revenue attributable to the double-tax system, nor is it proper to characterize foregoing collection of revenue under the passive loss rules as an "erosion" of the double-tax base.

Even to the extent that MLP investment substitutes for investments made by corporations, there may be little or no loss of double-taxed revenue from such investment over the next 5 years. As mentioned above, many uses of an MLP by existing corporations allow firms to finance investments using outside funds contributed by investors in the MLP, instead of borrowing the funds for the investment. This is simply a substitution of one single-taxed method of finance, MLP equity, for another, debt. No erosion of the double tax results in this case.

Some MLP investments may substitute for corporate retained earnings, which constitute about 80% of all corporate equity investment. But even in this case, there is no near-term revenue erosion from such substitution; indeed, there is a near-term revenue increase. To the extent that MLP investment substitutes for corporate retained earnings, the infusion of outside equity from the MLP investors allows the firm to lower retentions and thereby to raise dividends or to maintain dividends that would otherwise have been reduced to fund the investment.

In the near-term, therefore, the substitution of MLP equity for retained earnings raises revenues by increasing dividends and the resulting dividend tax. Conversely, preventing corporations from having access to outside MLP equity funds will induce them to increase retained earnings and, consequently, to restrain further the payment of dividends, leading to a loss of current tax revenues. In the future, the increased retained earnings resulting from taxing MLPs as corporations may lead eventually to higher revenues as the income on the equity investment gives rise to future dividends.

The only near-term source of a revenue loss from MLPs arises to the extent that MLP investment substitutes for investment that would have been financed by new corporate share issues. Investment financed by new corporate share issues gives rise to near-term double-tax revenues when that investment generates income, a portion of which is paid out as dividends and, thus, double taxed. No doubt because of such a double tax burden on new shares, over the period 1950 through 1985 only about 8% of net corporate investment was financed by new share issues. (See Table 2 below.) It is unlikely that much MLP investment actually will substitute for new corporate share issues, but, to the extent that it does, some reduction in double-tax revenues may result. In the short run, however, this reduction may be offset by the additional taxes on the payout of corporate income as dividends when corporations use MLPs as a source of outside equity funds in lieu of using retained earnings.

Tax Neutrality and Capital Investment

The fundamental tax policy standard by which MLPs should be judged is their impact on the neutrality of the tax system as it affects U.S. capital markets. To tax MLPs as corporations, thereby pushing the capital raised by MLPs into the double tax regime, would make the tax system less neutral, since most capital investment in the United States bears at most a single tax.

Ideally, a tax system should not render the cost of capital for investments undertaken in one sector or in one form more or less expensive than if undertaken in a different sector or form. The proper focus of tax neutrality is whether one form of investment requires a higher pre-tax return than other investments. The focus of neutrality is not whether investors in corporations, for example, receive lower after-tax returns than investors in single-taxed investments. The after-tax return to the investor is not a question of tax neutrality at all, since, even in the presence of tax differentials, competitive capital markets insure equal after-tax returns to investors.

Tax neutrality is properly analyzed by comparing the effects of taxation on the required pre-tax return of one type or form of

investment with that of all other investments. It is not adequate simply to compare the tax treatment of organizations with similar business structures. Achieving equal tax treatment of investments undertaken by entities with similar organizational characteristics merits no greater significance than achieving equal taxation of investments undertaken by entities with markedly different organizational characteristics.

U.S. capital markets are highly interrelated and competitive. New investment projects in any sector or industry must compete for funding with all other investments in the U.S. economy. ^{5/}

If most investment in the United States bears the higher cost of capital attributable to the double tax, then tax neutrality may be improved by subjecting single-taxed investments to the double tax. On the other hand, if most capital investment in the United States bears the lower cost of capital attributable to the single tax, tax neutrality clearly would be worsened by subjecting some single-taxed investments to the double tax.

In fact, most capital investment in the United States bears a single tax or less.

The extent of double versus single taxation in the U.S. depends on the mix of corporate, non-corporate, and non-business investment, and on the way in which corporate investment is financed. Table 1 shows the distribution of net investment in the United States over the period 1950 through 1985 by the three broad categories: corporate investment, non-corporate business investment, and non-business investment.

TABLE 1

U.S. Net Investment Shares 1950-1985 ^{6/}

Corporate	42%
Non-corporate business	24%
Non-business	34%

Non-corporate business investment, which includes investment by MLPs, is single taxed. Non-business investment, which is primarily investment in owner-occupied housing, is tax exempt. Only the 42% of total investment that is corporate investment is potentially subject to double taxation -- and only a portion of that investment actually is double taxed.

Clearly corporate investment that is financed by debt is single taxed. Further, as explained below, corporate investment financed by retained earnings is essentially single taxed also. It is only corporate investment financed by new share issues that is subject to the full double tax. Thus, to determine the extent of double taxation of U.S. investment, the financing mix used by corporations must be applied to

^{5/} For example, the rapid expansion and growing sophistication of the secondary mortgage market has closely tied the mortgage debt market to the general business market for borrowed funds.

^{6/} Source: Commerce Department statistics on constant dollar net capital stocks by type of business.

the overall corporate investment share. Table 2 shows the share of corporate investment financed by these alternative sources over the period 1950 through 1983.

TABLE 2
The Corporate Financing Mix 1950-1983 7/

Debt	44%
Retained Earnings	48%
New Share Issues	8%

Applying these figures to those in Table 1, the overall distribution of U.S. investment by tax category can be calculated. The single tax category includes non-corporate investment (24%) plus the corporate investment financed by debt (44% of the 42% of total investment that is corporate, which equals 18%). Overall, then, the single-tax category is 42% (18% plus 24%). The partially double taxed category is the share of corporate investment that is financed by retained earnings (48% of 42%). The only double taxed investment is the 8% of corporate investment financed by new share issues. Thus, overall, the double tax share is 8% of 42%, which equals 3%. The distribution of investment by tax category is summarized in Table 3.

TABLE 3
U.S. Investment by Tax Category

Non-taxed	34%
Single-taxed	42%
Partially double-taxed	20%
Double-taxed	3%

Investment Financed By New Shares Is Double Taxed

Corporate investment financed by the issuance of new shares must earn a pre-tax return higher than the return required for a single-taxed investment (e.g., one financed by debt) in order to pay the shareholder his required after-double-tax rate of return, because corporate investments financed by new share issues are double-taxed.

Example: Assume 50% tax rates on corporations and individuals and a required 4% after-tax return. A \$1,000,000 investment financed by new shares must earn \$160,000 (16%) pre-corporate tax to provide \$40,000 of after-tax dividends to individuals (a 4% return). This 16% required return reflects the double taxation of the investment. Single-taxed investments need only earn \$80,000 (8%) to provide \$40,000 of after-tax return to individual investors.

7/ Source: Federal Reserve flow of funds data. Data after 1983 are not used because there was a surge in repurchases in corporate stock during 1984 through 1986. This made the share of investment financed by new stock issues negative. Such data would reinforce the conclusion of this statement, but may only represent a temporary phenomena and, therefore, that data has not been included.

The Tax Cost of Investments Financed By Debt and Retained Earnings Are Similar

The tax treatment of debt and retained earnings is equivalent -- both are effectively single-taxed.

Debt. Debt finance is single-taxed.

Example: Assume 50% corporate and individual tax rates and a 4% required after-tax return. A \$1,000,000 debt-financed investment must earn 8% in order to provide a 4% return to individuals.

Retained earnings. The pre-tax rate of return required to be earned on a retained earnings investment in order to provide a shareholder with the requisite 4 percent after-tax rate of return is equivalent to the rate of return that would have to be earned on a debt-financed investment. Thus, from a cost-of-capital perspective, retained earnings investments are the equivalent of single-taxed investments (i.e., debt-financed investments and partnership investments).

Example: \$1,000,000 of after-tax income in a corporation can generate \$500,000 of dividends after tax for an individual to invest, for example, by loaning the funds back to the corporation. \$500,000 loaned to the corporation at an 8% interest rate returns \$520,000 after tax to the investor after one year.

If the \$1,000,000 is retained and invested by the corporation at 8% -- the required return on single-taxed debt -- the investor will receive after-tax dividends of \$520,000 after one year. (The corporation earns \$80,000, pays tax of \$40,000, and distributes the remaining \$40,000 plus the original \$1,000,000 to the investor, who is left with \$520,000 after tax.)

Accordingly, debt-financed investment and investments financed by retained earnings require the same 8% pre-tax rate of return. 8/

It may seem puzzling that investments financed with retained earnings are effectively single-taxed, since the future income stream on the investment obviously is taxed twice. The crucial point is that, while there will be future dividend taxes when the income from the investment is distributed, such taxes are offset by the personal tax saved by retaining rather than distributing current earnings. That is, if current earnings are not retained, they must be paid out as dividends incurring a current personal tax. Thus, retaining earnings provides a current personal tax saving. The dividend taxes that are saved currently exactly offset, in present value, the future dividend taxes from the investment financed by retained earnings. As the example given above reveals, the only net tax on the investment, therefore, is the corporate tax itself. Accordingly, investments financed by retained earnings are single taxed.

8/ For clarity, the examples have used 50% tax rates. Under current law, the single tax rate that applies to investments financed by retained earnings is 34%, the corporate tax rate. The tax rate that applies to debt, however, is presumably about 28%. Thus while both are single taxed, investments financed by retained earnings are taxed at a slightly higher rate.

Capital gains taxes and retained earnings

Since the current dividend tax savings cancels out the future dividend taxes on investments financed with retained earnings, the traditional double tax on distributed corporate earnings does not affect the required pre-tax return on retained earnings investments. Capital gains taxes, however, may have a small effect on that required return.

Sales of stock whose value has risen due to retentions of earnings result in a partial double tax on investments financed with retained earnings. For a 28% statutory rate, this partial double tax is only around 2.8%. 9/ Further, the capital gains on such realizations will induce a subsequent offsetting loss that arises when the increase in stock value from retention of the earnings is eliminated upon payout of the earnings as dividends, and the stock is thereafter sold.

Thus, even including the effect of capital gains taxes, investments financed by retained earnings are essentially single-taxed.

I realize these examples are complex and that they require study and thought, but their lesson is straightforward. An attempt to subject MLPs, or any other category of partnerships, to the corporate double tax because they resemble corporations in certain respects would not be a move toward neutrality in the tax system. It would be a significant step away from neutrality because --

- ° U.S. capital markets are highly integrated and those seeking funds for new investments (whether or not in the corporate sector) must compete for funding with all other investments in the U.S. economy.
- ° Whether by design or accident, most capital investment in the United States bears a single tax or less -- single taxation is the norm.
- ° In the corporate sector alone, only 8% of investment is financed by new share issues and the balance of corporate investment is financed by either debt or retained earnings, both of which are effectively single taxed -- double taxation is the exception.

Thus taxing MLPs as corporations cannot be justified as a step that will improve the fairness or neutrality of the tax system.

The Inevitability of Some Inequity if Double and Single Taxation Exist

In spite of the evidence just presented, some suggest that MLPs add an element of unfairness or inequality to the tax system in the sense that one taxpayer may be taxed more harshly than another similarly situated taxpayer. For example, one proponent of taxing MLPs as corporations has asserted that it is not fair for a corporation such as General Motors to incur a double tax when it issues new shares while an MLP can raise new equity that is single taxed.

9/ The size of the capital gains double tax depends on the share of stock held by individuals that is sold each year. Treasury data on sales of stock by individuals in 1973, 1977, and 1983 and Federal Reserve data on holdings of stock by households in 1973, 1977, and 1981, adjusted to exclude nonprofit organizations, indicate that about 10% of all stock is sold each year. Consequently, the capital gains tax rate on total retentions is 10% of the ordinary income tax rate (28%), or 2.8%. This makes the combined tax rate on investments financed by retentions around 36%, using a 34% corporate rate. This is in contrast to a 53% tax rate on new stock issues using a 34% tax rate and a 28% individual rate. The 1988 tax rate on debt under current law is presumably about 28%.

It must be understood that, unless this Subcommittee is willing to apply the double tax to all U.S. investment, including sole proprietorships and debt finance, or is willing to eliminate the double tax on all new corporate investments, this concern over inequity can not be eliminated. Wherever the line is drawn between double-taxed and single-taxed investments or entities, someone can come before this Subcommittee and describe taxpayers on the other side of this line and point to an inequity. ^{10/}

As long as only some investment is double taxed, some inequity is inevitable. The issue before this Subcommittee is whether moving the line to expand double taxation worsens or improves overall tax equity. The evidence of the previous section demonstrates that single taxation is the norm in the United States. The more investment that is taxed at the norm, the greater is competitive tax equity in the United States. Accordingly, expanding the amount of investment that is double taxed worsens competitive equity, it does not improve it.

^{10/} It should be noted there is no particular logic in selecting publicly-traded partnerships for the double tax. It is true that large publicly-held partnerships have many similarities to publicly-held corporations. But medium-sized partnerships have many similarities to medium-sized corporations, and closely-held partnerships are in many respects the same as closely-held corporations.

Chairman RANGEL. Mr. Ballentine, do you have testimony?

Mr. BALLENTINE. No, sir.

Chairman RANGEL. Then we will hear from Mr. Cain.

STATEMENT OF EDWIN E. CAIN, VICE PRESIDENT FOR GOVERNMENT RELATIONS, APACHE CORP., ACCOMPANIED BY MICHAEL VALADEZ, CORPORATE COUNSEL, APACHE CORP.

Mr. CAIN. Thank you, Mr. Chairman and members of the subcommittee.

I appreciate the opportunity to present testimony at these hearings today. I am Edwin Cain, vice president, Government Relations for Apache Corp., an oil and gas company headquartered in Denver, Colo., and listed on the New York Stock Exchange.

With me is Michael Valadez, corporate counsel for Apache Corp.

Apache is sole general partner of Apache Petroleum Co., a publicly traded limited partnership also listed on the New York Stock Exchange.

Little did we realize when we offered our investors in 33 limited partnerships an opportunity to exchange their units into a single publicly traded partnership that we would get all this attention from you gentlemen of this committee and from Treasury.

It is important to note that APC was and is—it is important that we know that APC was and is in all respects a partnership falling squarely within the definition of a partnership contained in Treasury regulations.

The IRS issued us a favorable ruling to this effect and subsequently to other publicly traded partnerships as well.

Today I would like to highlight several of the points in my written testimony that examine some perceived problems attributed to the establishment, development and growth of the master limited partnership structure.

With regard to the question of loss of revenues, we contend that quite the opposite is true. First, when Apache rolled up 33 oil and gas limited partnerships into a single traded partnership, several things occurred that we believe is good for all parties involved.

The investor received a liquidity in his investment with an established market price given to his property.

Second, the company was given a mechanism to raise new capital and was to consolidate reserves and capital in such a way as to permit the development of our Nation's natural resources.

The third party, the partnership of the U.S. Government, has also profited from the development of master limited partnerships.

First, the capacity for new exploration and development creates new revenues which would otherwise not be available.

Second, the consolidation of our 33 partnerships into one traded partnership created no revenue loss because both were taxed under the same laws and the same regulations.

In fact, there is likely a gain to Treasury in the process as the investors gave up substantial amounts of percentage depletion when these units were exchanged. When their units were sold, they were subject to capital gains and also substantial amounts of income tax recapture of such items as IDC and investment tax credit.

The difficulties in corporate concern expressed as an erosion of the corporate tax base would require much of the 21st century before it becomes a significant problem.

The organization of 127 master limited partnerships in 6½ years out of the tens of thousands of businesses operating in the United States is hardly an epidemic.

The MLP format and structure is narrowly adaptable to specific industries and is extremely costly to provide the administration and reporting procedures required to operate a publicly traded partnership.

The taxation of master limited partnerships as a separate entity from other passthrough structures is grossly unfair. A publicly traded partnership is virtually the only investment in which a small investor can receive the same sorts of tax advantages and opportunities as a large investor.

Because of the unrelated business taxable income provision institutional investors simply do not participate in master limited partnerships.

Contrary to corporate investors nearly all investors in MLBS are individuals. A profile of the typical APC investor was conducted by Chip Hayssen, treasurer of the investment firm of Piper, Jeffrey & Hopwood in Minneapolis.

The average investor owned less than \$5,000 in APC units with listed occupations as teacher, retiree, bank teller, and truck drivers. Large individual investors were a rarity in the report.

In conclusion, Apache invested a sizable sum to assure proper compliance, accurate reporting and simplicity for both the investors and for IRS.

The preservation of the MLPs is very important for the domestic oil and gas industry. The MLP has proved itself to be a very promising capital-raising mechanism for an industry that has now been deprived in large part of its historical means of doing just that.

This cutoff has occurred at a time when the need for capital by the industry is more critical than ever.

I suggest that Congress should stop, look and listen before it takes any steps that would adversely affect the current classification of master limited partnerships as partnerships and certainly in the case of those MLPs that serve the oil and gas industry.

[The statement of Mr. Cain follows:]

Statement
Of
Edwin E. Cain
Vice President Government Relations
Apache Corporation

My name is Edwin E. Cain. I am Vice President Government Relations, for Apache Corporation, a company headquartered in Denver, Colorado and listed on the New York Stock Exchange that is engaged in the oil and gas business. Apache is sole General Partner of Apache Petroleum Company ("APC"), a publicly traded limited partnership also listed on the New York Exchange. APC, organized in 1981, was the first master limited partnership to have its units traded on any national exchange. Today, I appear in support of the proposition that master limited partnerships ("MLPs") such as APC are properly classified as partnerships for income tax purposes, not as corporations, and that they should continue to be so treated.

Since 1959, my company, Apache, as an independent oil and gas developer and producer has sponsored 68 public partnerships that have explored for and developed oil and gas properties. This activity has involved over 30,000 investor/partners and raised over \$750 million for investment in oil and gas exploration and development. In addition, Apache created APC by consolidating 39 of its then-existing public oil and gas partnerships in one publicly traded partnership. We accomplished this reorganization for reasons that have best been described by my chairman, Raymond Plank, in testimony given by him before the Committee on Finance of the United States Senate in 1983 at hearings on the income taxation of corporations.^{1/} Let me quote briefly from Mr. Plank's testimony (at page 327):

"In 1981, we at Apache served as general partner of [over thirty] public partnerships. It was altogether clear to us that, in order to stimulate further development of these reserves and values to our investors, it was necessary to consolidate these partnerships in a single partnership with much greater financial strength and a capacity to undertake further development. This we did, by giving out investors the option -- which they exercised in overwhelming numbers -- to exchange (or "roll up") their existing units for new partnership interests in APC, which units were then listed on the New York Stock Exchange. However, APC was, and is, in all respects a partnership . . . falling squarely within the definition of a partnership contained in Treasury regulations (the Internal Revenue Service issued us a favorable ruling to this effect, as it has done to several other publicly traded partnerships).

^{1/} "Reform of Corporate Taxation," Hearings before the Committee on Finance, United States Senate, 98th Cong., 10th Sess., pp. 324-340.

I am happy to report that the market response to APC since 1981 has been excellent. Our reserves are approaching \$1 billion. We have made a second successful exchange offer. We have made substantial acquisitions of oil and gas properties in exchange for units and have successfully sold in the market over \$80 million in new partnership units. Today, APC has a balanced and diversified program of exploratory and development drilling and the operation of income-producing properties . . .

I can report to you that the creation and subsequent operation of APC has resulted in more total income tax being paid to the Federal Government than would have been the case if the investors had not acquired APC units. As a consequence of our exchange offers, our original investors forewent substantial amounts of percentage depletion when they exchanged their old interests for tradable units; many of them (who could not otherwise have done so) subsequently have sold their new units not only subject to capital gains tax but also at the cost of being taxed on substantial amounts of income tax "recapture" of such previously deducted items as intangible drilling costs and the investment tax credit. What happened is not surprising: the creation of a new and more effective vehicle for putting capital to work in the oil and gas industry has not only stimulated production and jobs but has produced taxable income for the Government that would not otherwise have resulted. Just as the reduction of the capital gains tax rate in the first year of the Reagan Administration demonstrably produced an increase in total tax receipts from capital transactions, so too has APC stimulated an increase in tax receipts from the ownership of partnership units."

Since 1983, when Mr. Plank testified, APC, like the entire domestic oil and gas industry, has been adversely and greatly affected by the calamitous decline in the price of oil and gas occasioned by the machinations of the OPEC governments. APC has, for example, been required to write down its oil and gas assets and drastically curtail its exploration activities (a situation which we hope will be temporary). Nevertheless, the experience of APC demonstrates that an MLP is a most useful mechanism for raising capital to develop our domestic oil and gas resources. The formation of APC resulted in greatly increased economic activity and, I firmly agree with Mr. Plank, in increased revenues for the Federal Treasury. APC also provided diversified investment opportunities in oil and gas production for investors of modest means, not just for wealthy investors. Until early 1986, when oil and gas prices fell off the roof, APC partnership units were priced by the market at values much more closely corresponding to the value of their underlying oil and gas properties than was the case for corporations investing in comparable properties.

As a consequence, it is hard for me to see how Congress can now seriously consider acting to stifle this extremely useful investment vehicle, of particular importance to the independent sector of the domestic oil and gas industry, at least on the evidence that it now has before it. This evidence, as I understand it, is largely conceptual: it is said that MLPs, possessing tradable investment units, apparently "quack" like corporations and that their development is some form of "private integration of the corporate and individual income taxes." These arguments don't make much sense to me. In my experience, APC as a limited partnership is functionally quite different from a corporation.^{2/} Its development was a normal (and, in economic terms, highly desirable) application of long-standing rules governing the income taxation of partnerships and their partners.

Partnerships, with their flow-through of income, have long been a preferred vehicle for cash-generating businesses that develop large-scale assets without diversifying into other types of businesses. The market has for many years valued underlying corporate assets very differently from partnership assets, generally discounting corporate assets by a substantial margin. For this reason, partnerships have been favored over corporations in the natural resources area for the direct development of assets, most of all in the case of oil and gas. Until publicly traded partnerships were developed, a large price for this preference was paid by investors: lack of liquidity. In APC's case, the partnership format -- the traditional vehicle utilized by the independent oil and gas industry to raise its capital -- was employed in a new and creative way in response to market requirements and the needs of the industry. I suggest that our response was a praiseworthy one, in the best traditions of our entrepreneurial free market system.

I have also heard critics of MLPs state that it is difficult for such partnerships to comply with the partnership provisions of the Code, particularly those governing the allocation of tax items to partners and the reporting requirements placed on partnerships and partners. I believe these criticisms are greatly exaggerated. In fact, in my opinion, quite the reverse is true.

Of all businesses, MLPs are probably the "cleanest" in audit terms, mainly because they cannot afford as a marketing matter to run the risk of any serious audit affecting each of their thousands of partners. They have invested many hundreds of thousands of dollars in sophisticated computer systems, which have enabled them to provide information to their partners in a manner that should be the envy of all partnerships. The tax information and K-1s provided to partners by APC are as complete, detailed and informative as that provided by any large partnership. In particular, I believe our experience has demonstrated the following:

^{2/} Again for reasons more fully developed by Mr. Plank in his testimony at pp. 335-337. See footnote 1 supra.

- Our methods of allocating partnership items to partners, notwithstanding the fact that units are traded on an exchange, are fair, non-abusive and have substantial economic effect. In my judgement, they fully comply with income tax laws governing the taxation of partnerships and partners. If problems exist, these are largely the result either of out-of-date regulations or of the fact that the Treasury has yet to issue certain proposed or final regulations.
- The problem of providing partners with satisfactory K-1s, and obtaining the information necessary to permit the partnership to issue such K-1s, has largely been that of identifying partners whose interests are held in "street name" accounts. I believe this problem has been cured by the 1986 Act, which now requires nominee holders of partnership interests to provide certain necessary information regarding street name accounts to the partnership.
- It has been said that publicly traded partnerships cannot know when partnership termination occurs under section 708 of the Internal Revenue Code if more than 50% of the partnership interests are traded in a twelve month period. We believe that we have established satisfactory methods of monitoring the trading in our units so that we can predict and avoid termination under section 708. In any event, if such termination were to occur, we believe the tax consequences would be fully reported to the appropriate investor/partners.

I do not want to be understood to suggest that MLPs are not costly and complex in managing their investor partner relationships as compared with corporations and their investor/shareholders. MLPs are, in fact, both costly and complex in such administrative matters. However, for those domestic oil and gas operators who seek new sources of capital and for those small investors who want to invest in oil and gas operations and are willing to accept the normal consequences of investing as partners, there is no substitute for a master limited partnership.

I should emphasize that the need today for MLPs as capital-raising vehicles for the oil and gas industry is more vital than ever before. We know that, with the collapse in domestic oil and gas prices, domestic oil and gas production has plummeted. According to Robert Stenger, who appeared before this Subcommittee yesterday, the total amount of public and private investment in oil and gas drilling fell from \$2.7 billion as recently as 1981 to \$186 million in 1986. As the New York Times reported in its issue of June 24, 1987, what is more ominous is that, from the point

of independent oil and gas operators, current trends in investment favor the majors, not the independents and smaller producers.^{3/} I agree with this conclusion; the independents and smaller producers have, historically, relied heavily for capital on direct investment by high tax bracket individuals, whether as direct investors, general partners, or as limited partners in illiquid partnerships. Much of this investment was stimulated by the tax advantages theretofore available to those investors who could take advantage of them. As everybody knows, the 1986 Tax Act, in reducing the attractiveness of oil-related tax shelters, has made life more difficult for such independents. The elimination in the 1986 Act of the investment tax credit now makes exploration in the continental United States less attractive than it was. As reported in the Times, all these trends are believed by informed observers to play into the hands of the big companies. As one analyst is reported to have stated, "Until the upturn is definitely here and everybody can touch it, investment capital will stay largely with the majors, leaving many of the smaller independents financially starved."^{4/} Thus, it will increasingly be the stronger oil companies that will have access to oil and gas properties.

I concur in the foregoing analyses of the current situation for the domestic oil and gas industry, particularly for the independent and small producer sector. Continuing access to capital by this sector is vital. I do not go so far as to suggest that the preservation of MLPs is very important for the domestic oil and gas industry; the MLP has proved itself to be a very promising capital-raising mechanism for an industry that has now been deprived, in large part, of its historical means of doing just that. This cut-off has occurred at a time when the need for capital by the industry is more critical than ever. I suggest that the Congress should stop, look and listen before it takes any steps that would adversely affect the current classification of master limited partnerships as partnerships, certainly in the case of those MLPs that serve the oil and gas industry.

^{3/} New York Times, June 24, 1987, p. D-1.

^{4/} New York Times, *supra* at p. D-7, quoting William J. Kimmel of Kidder, Peabody & Co.

Mr. FLIPPO [presiding]. Mr. Neafsey.

**STATEMENT OF JOHN P. NEAFSEY, EXECUTIVE VICE PRESIDENT
AND CHIEF FINANCIAL OFFICER, SUN CO., INC.**

Mr. NEAFSEY. Thank you. My name is Jack Neafsey. I am an executive vice president and chief financial officer of the Sun Co., which is a large integrated domestic oil company.

I would like to just review some of the fundamentals of the oil industry. The industry is one which is constantly regenerating its most important asset—its oil and gas reserves. It does this typically through the reinvestment of cash flow, which is generated from its production operations. It takes this cash flow and reinvests it into new capital projects which is then constantly regenerating these reserves.

However, either in good years when the number of opportunities that we have in front of us for investment are abundant, or in bad years such as we experienced during the year 1986, the amount of cash flow which is forthcoming from our production operations may not be sufficient to sustain the industry.

In those periods of time additional capital funding is required and that capital funding can come from only one of three sources, from debt, from incremental equity or from a hybrid vehicle such as a master limited partnership. I would like to talk about each source of funding.

Before I do that it is important to recognize the risk reward relationship that is attendant to this industry. There are two types of risks. One is geological risk, and we have been dealing with geological risk for roughly a hundred years. It is a statistical phenomena and we can handle that through statistical techniques.

Roughly, one in nine exploratory wildcat wells will be successful according to statistical techniques. We can well accommodate for that risk. But there is a second risk which in recent times has been more pervasive, price risk. In 1986, we started the year with West Texas intermediate crude selling for \$26 a barrel.

By the early part of August, it had fallen on the spot market to below \$10 a barrel. It recovered to \$15 a barrel, fell back to \$13 a barrel and ended the year at \$17 a barrel, and now it is in excess of \$20 a barrel. That is a roller coaster by anybody's definition.

With respect to price risk, these wild swings can neither be predicted nor compensated for through statistical techniques, but they can be accommodated through financing vehicles such as the master limited partnership. If we look at the three alternatives, debt, equity and a hybrid vehicle, debt is often very inappropriate for a high-risk venture such as drilling oil and gas wells.

You should not be borrowing money from a bank or any source of funds for debt capital in order to proceed with exploratory projects. With respect to equity, it is too expensive to raise money or incremental funds in the equity market in order to finance new capital projects. When you look at what you are doing with respect to raising money in the equity market, you are selling a portion of your existing reserves, a portion of your existing production, and unless you get a fair price for that, you are diluting your existing

stockholders, which is a breach in your fiduciary responsibility to them.

So that leads you to search for a hybrid such as master limited partnership. And that is exactly what we searched for, what we found and what we issued in December of 1985. If I can illustrate our particular situation, we formed our MLP in December of 1985. At that point we estimated, despite the fact that crude was selling at roughly \$26 a barrel, that price might fall to \$24 a barrel as an average for the year 1986.

Obviously, the year turned out to be somewhat different than that. We estimated that based on our price forecast that there would be distributable cash of \$2.90 available for the investor during 1986.

In reality the distributable cash turned out to be \$1.76, so obviously there was a sharing—the investor perhaps shared more risk than he had anticipated in the very first year of this project, but there was a real sharing of risk and reward with respect to the MLP, a phenomena that would be very different if we had financed through equity or debt.

The investors paid \$25.20 a unit and he was promised on the basis of the anticipated distributions an 11 percent rate of return, so that is the reward part of the risk/reward ratio. We could have offered debt units or debt securities at that time at an average rate of perhaps 8½ to 8¾ percent.

If you look at the efficiency from the Treasury standpoint the Treasury would have been far more disadvantaged had we issued debt securities to fund that incremental capital request than if we had used the MLP route.

If we examine what happened, as I indicated, the price fell, the cash distribution fell and—in the first year at least—the investor was experiencing more of the risk curve than the reward curve. But over the long-term this is a vehicle which is ideally suited to the fundamental nature of this industry.

The MLP has been demonstrated, in our industry, to be a very effective and very efficient means of financing incremental capital. It is not a means of replacing the base load business. The Sun Co. continues to own over 97 percent of the MLP units, so over 97 percent of all the cash flow emanating from our production operations continues to be taxed through the corporate vehicle.

If we were looking for a means of escaping taxation, this is a terribly inefficient way to do it in that 97 percent still remains to be taxed as a corporation. We were not driven by tax considerations but by the fundamental risk/reward characteristic of this business.

It is not a substitute for equity in particular and any comparisons between the cost or the revenue-raising opportunities in the equity market versus the MLP market is not relevant because the dilution that one would experience by raising new capital through the equity route is too expensive for any corporation to seriously contemplate.

From the investor's standpoint I think it is a very well suited vehicle. It provides liquidity, which is very important particularly for the little investor. It provides a fair deal for direct investment into the oil and gas business. It is not the kind of deal which might be

highly promoted or not associated with a large reputable corporation such as ourselves.

It does provide an opportunity to engage in a partnership with a large, highly reputable corporation which is going to continue to own between 70 and 90 percent of all the units outstanding.

Thank you for providing me the opportunity to share these thoughts with you this morning.

[The statement of Mr. Neafsey follows:]

STATEMENT OF JOHN P. NEAFSEY BEFORE THE HOUSE OF
REPRESENTATIVES COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HEARINGS ON THE TAX TREATMENT OF
MASTER LIMITED PARTNERSHIPS (MLPs)

JULY 1, 1987

Mr. Chairman and members of the committee, my name is John P. Neafsey. I am an Executive Vice President and the chief financial officer and a member of the board of Sun Company, an integrated energy company with operations primarily located in North America.

My testimony is intended to demonstrate that, in the case of Sun Company, the decision to form a master limited partnership was driven by a concern to realize full value of our energy producing assets and to raise new capital for reserve additions, not by a desire to avoid federal taxes. Changes in the Tax Reform Act of 1986 did not and will not materially affect our decisions with respect to our MLP. Certainly the changes in tax rates, the passive loss changes and numerous other provisions of the Tax Reform Act of 1986 have an impact on investor decisions and the entire area of capital formation. However, the decline in the price of crude and its resulting impact on the cash flow of our MLP units so overshadows tax reform as to make the consequences of reform almost imperceptible.

Future decisions by Congress to add an unanticipated tax burden to this type of capital formation would adversely affect current holders of MLP units as well as our decision to raise future capital by selling additional units.

FINANCIAL AND BUSINESS DECISIONS LEADING TO THE
USE OF SUN'S MASTER LIMITED PARTNERSHIP

In December of 1985, Sun Company transferred all of its domestic oil and gas properties and related assets and liabilities to Sun Energy Partners, L.P., a master limited partnership. The properties consisted of approximately 8 million acres of which 2 million were developed, located in 37 states and in federal and state waters. In the same month, 2.7% of the partnership units were sold to the public at an initial offering price of approximately \$200 million or \$25 per unit. Based on estimated cash flows, and assuming a crude oil price of \$24, Sun indicated in its prospectus the intention of distributing \$2.90 per unit for 1986 and 1987.

To understand the primary motive behind Sun's use of the MLP it is necessary to look at the recent history of the oil industry especially from the viewpoint of a mid-size domestic company.

In the U.S. the success ratio for wildcat exploration has remained relatively constant at about 1 in 8. Companies like Sun had statistically compensated for this risk by participating in numerous exploratory wells thus permitting reasonable expectations of a 1 in 8 success ratio. Independents covered this risk primarily through the use of outside equity capital provided by investors with sufficient capital to underwrite the risk. Limited partnerships were often used as a vehicle to raise this capital.

By 1985, the slow decline in the real price of crude oil was negatively impacting the industry's drilling activities and the risk associated with adding new reserves. Sun's capital expenditures for exploration and production had significantly declined. It remained a primary objective for Sun to minimize the decline in its domestic oil and gas reserves and the MLP proved to be an efficient method to help in achieving this objective. It was well suited to the risks and rewards inherent in a business we saw becoming increasingly volatile. Debt instruments as a source of incremental capital were, in our opinion, an imprudent method of funding this higher risk exploration although a number of companies had chosen this route of financing. Finally, our common stock was selling at a price which made equity financing too expensive.

Adding to the risk were policy decisions made at the federal level. Sun had paid almost \$1.8 billion in windfall profits tax since 1980 which drained capital from our exploration activity. In addition, federal leasing policy and state environmental restrictions were limiting the availability of more favorable exploration prospects thus adding to the risk of exploration.

Throughout the 80's, there was added to the physical risk of finding oil, the very real financial risk of being totally unable to predict what the oil may be worth. The price range for oil discovered in 1985 was estimated to be somewhere between \$5 and \$50, based primarily on the political decisions of a few Mideast countries.

In short, Sun Company needed risk capital and we considered it imprudent to borrow it and too expensive to raise it through equity. This concern was well founded in view of the precipitous drop in crude prices in early 1986. Let me assure the members of this Committee that at this point avoiding federal corporate income tax was not high on my list of priorities. The November, 1986 issue of Petroleum Management (p.17) includes an article describing, in industry terms, what Sun Company faced and continues to face with respect to financing the search for oil. One conclusion the author reaches is the real role an MLP can play in the search for oil. With one exception, quoted below, this conclusion is reached without reference to the Internal Revenue Code.

"Many of the limited partnerships and royalty trusts would provide excellent examples of instances where the industry is beginning to depend on the investors for funds, rather than depending on production revenues. However, most of these partnerships and trusts were cast as tax shelters, rather than as commercial ventures. Perhaps the biggest drawback of this shaping by tax considerations is the clouding it may impart to our ability to appreciate the possibility of limited partnerships and royalty trusts as pure commercial ventures of the kind we are suggesting here".

In 1985 we had little option but to look to a hybrid financing vehicle the primary purpose of which was to raise risk capital in a prudent and cost-effective manner. At that time other companies had formed MLPs and we were afforded the opportunity to assess the cost of capital by looking at the market price of these securities. It proved the least expensive way of raising capital at that time. When we compared the price the public was willing to pay for our reserves in the form of common stock to the price they would pay for direct ownership through an MLP, we discovered a significant difference in favor of the MLP. The value differential can be explained by the substantial undervaluation of oil stocks as compared to the value of the underlying oil production assets. In 1985, the MLP market yielded \$8.00 per barrel for our reserves, while the common stock market valued our reserves at \$4.00 per barrel. Another reason for the differential is the distribution policies of MLPs. Because MLPs distribute all, or most, of their cash flow, they provide a high yield investment return. The direct relationship of cash flow distribution, investor yield, and unit value of an MLP was demonstrated later in 1986 when the dramatic collapse of oil prices cut the distribution, yield and unit price. From the investor's perspective the elimination of double taxation of earnings is an important consideration, but there are also many non-tax considerations which go to the heart of the investment. These include:

- o direct ownership in oil and gas production assets;
- o greater potential profit associated with a recovery of oil prices;
- o new investment opportunity for upper middle income individuals;
- o higher cash yield;
- o greater liquidity.

THE IMPACT OF MASTER LIMITED PARTNERSHIPS
ON FEDERAL REVENUE

The revenue effect of MLPs falls into two broad categories: the effect of MLPs on the double taxation of corporate equity, and their effect on other timing and recognition of taxable income by unit holders. MLPs and corporations differ in capitalization and distribution policy. MLPs distribute a high percentage of cash flow, while corporations typically reinvest a high percentage of retained earnings as a source of capital.

Taxation of corporate income at the shareholder level occurs upon distribution of earnings. Income earned in corporate form is often not distributed currently in the form of dividends, but is instead realized by the investor upon disposition of ownership or avoided by distribution at death. In contrast, earnings of MLPs are generally taxed to the unit holder currently whether distributed or not. Although the MLP is not subject to a corporate level tax, the tax at the unit holder level is accelerated relative to the taxation of retained earnings to the shareholder of a corporation.

To the extent that capital raised through MLPs is more likely to replace capital formerly raised through debt than through newly issued equity, MLPs will not eliminate a second layer of tax, since the capital raised by debt would have carried no double tax. In an article by Robert J. Leonard, Chief Counsel to the House Committee on Ways & Means (Tax Notes, June 1, 1987, pp. 889,898) which is generally unsupportive of MLPs, the author recognizes that debt itself is a form of "self-help integration" currently available to corporations. His suggestions to overcome this problem would entail a significant change in corporate taxation which he recognizes is unlikely in the near future.

In addition to the double tax issue, MLPs will affect tax revenues due to timing and recognition issues.

MLPs may result in an acceleration of tax revenue where units are distributed to shareholders of the sponsor and where units are sold in a secondary offering. A shareholder recognizes taxable income equal to the value of the unit upon its receipt. The distributing corporation also recognizes any gain on the difference between its basis in the distributed unit and its fair market value. In a secondary offering the sale triggers tax on any inherent gain relating to the partnership's underlying assets. Thus, MLPs accelerate receipt of revenue to Treasury in certain circumstances.

The revenue loss associated with the step-up of basis at death would be reduced by the existence of MLPs. Since all income earned by a MLP is taxed currently, there will be less deferred gain on which revenues are lost at the death of shareholders. In contrast, retained corporate earnings may lead to large accrued gains many of which escape taxation through the step-up of basis at the death of shareholders. Any step-up in basis at death with respect to a unit in a MLP would reflect market factors other than retained earnings, resulting in a loss of tax revenues that would occur in corporate form also.

The numerous legal and operational costs inherent in the master limited partnership form of carrying on a business will likely result in confining the use of MLPs to single-purpose high risk activities generating substantial levels of cash flow. The tax exempt sector is unlikely to participate in the MLP market because MLPs generate "unrelated business income" taxable to those organizations. This will discourage MLP formation since tax exempts represent a major segment of the capital market. The corporate form will remain the preferred entity for diversified, multi-national or capital-intensive activities.

In summary, it is critical that the revenue analysis of MLPs takes into account the type of funds, debt or equity, that are replaced by MLPs. Also, the effect of MLPs on the overall corporate debt-equity ratio must be assessed. Equally important, the effect of MLPs on the time pattern of recognition of income by taxpayers must be incorporated in the analysis. While at first thought it might seem that MLPs represent a significant revenue leak from the corporate income tax, we believe that further analysis will show the revenue effect to be much less than it may at first appear.

SUMMARY

Sun considers the availability of its MLP as an important alternative in raising high risk capital. Any tax legislation which would increase the burden on this type of capital formation should only be taken if dictated by sound tax policy considerations. Currently it appears that the major concern of Congress is the possibility of an erosion in corporate tax collections. To date this concern does not appear to be justified. We therefore recommend that no legislative changes be made with respect to the current tax treatment of MLPs.

Chairman RANGEL. Mr. Lollar.

STATEMENT OF JOHN H. LOLLAR, PRESIDENT, TRANSCO EXPLORATION CO., ON BEHALF OF TRANSCO ENERGY CO., GENERAL PARTNER OF TRANSCO EXPLORATION PARTNERS, LTD.

Mr. LOLLAR. I am John Lollar, president of Transco Exploration Co., the managing general partner of Transco Exploration Partners, Ltd. I am here to urge you to not make changes with respect to the taxation of MLP's, especially those related to natural resources industries.

Transco formed its MLP in 1983, so we are not a newcomer to the scene. We did it for two reasons. First, to raise equity funds at a time when few investors would sit still for a sales pitch on an oil and gas deal and, second, to put a spotlight on the exploration and production side of Transco's business, an area where we felt we received a little recognition.

As a result, we raised about \$200 million in two public offerings. It used to be a very cost effective way to attract equity to the oil and gas industry, but the passive loss rule has changed that. I don't know how to estimate the real impact of the new passive loss rules, but I do know that our units are cheaper today than before the 1986 Tax Reform Act.

Our second objective was accomplished as well, because of the publicly traded aspect of Transco's MLP. With the exploration business valued at more than \$1 billion, the company's common stock rose from \$24 per share to \$42 a share. Considering changes in the tax status of publicly traded MLP's it seems to me is to unfairly pick on the small investor.

We now have about 70,000 unit holders in Transco exploration partners. Of the 75 million units outstanding about 74 percent are held by the company and 27 percent by the public. You can buy them from your broker. They are traded every day on the New York Stock Exchange. As I understand it, if we had raised the \$200 million from large investors in a private offering, I wouldn't be here today.

Just because our units are publicly traded, just because we brought the small investor into our exploration effort, to argue that that fact alone should make the partnership taxable—I don't see the logic there. The use of a limited partnership has always been a very important source of funds for the independent oil operator's exploration effort.

In the last 10 years nearly \$30 billion has been raised both privately and publicly through oil and gas limited partnerships. We ought to be considering ways to get more risk funds into domestic exploration instead of further restricting capital formation activities. I am concerned, as is just about everybody close to the oil and gas industry, with trends that are all going in the wrong direction, declining domestic production, declining reserves replacement, hardly any rigs working, increasing consumption, increasing imports, increasing imports from the middle eastern countries.

That is no way to help keep this country out of energy supply problems in the 1990's. Is there a loss of tax revenues as a result of MLP's? I don't believe there is at least for natural resource orient-

ed partnerships. For one thing most of the significant natural resource MLP's are owned by large corporate sponsors. Their ownership interests range from our 73 percent on up to more than 95 percent. This means that the businesses conducted by those MLP's continue to be exposed to corporate taxes to a very large extent.

Second, the funds raised have either gone to reduce debt or to support operations. Either will lead to added tax revenues, whether the money is spent to reduce interest expense or to buy drilling. In order to increase the yield being earned by their shareholders, several of the largest natural resources MLP's distributed units to their common shareholders.

The taxable income, I am sure, generated revenues to the Treasury, which would not have otherwise been generated. What does an MLP do? I thought it would be helpful if I gave you a summary of Transco exploration since forming our MLP in July of 1983.

We are a domestic exploration and production company. Everything we do is done through our partnership. Our business is to profitably explore for oil and gas largely in the Gulf of Mexico. Since mid-1983, our sources of cash have roughly been as follows: after tax cash flow from the sale of our oil and gas production, about \$700 million.

The \$200 million that I mentioned from the sale of—the public sale of our MLP offerings, net new debt, another \$200 million. A reduction in working capital, about \$60 million. You add that all up and that is \$1,160,000,000. And have we used those funds? Well, our distribution to unit holders has been about a hundred million dollars. The funds spent on exploration for this country is \$685 million; \$125 million of that went to purchasing leases in the Gulf of Mexico; \$240 million has been spent on development and the purchase of producing properties, about \$135 million.

Now the exploration business hasn't been all that good recently. We have been losing money since June of 1985. In fact at today's prices, especially natural gas prices, it is hard to explain why we have been exposing ourselves to the risk of exploration, but that is what we do for a living, and that is what we need more of.

Don't make tax changes that hurt capital formation and run counter to what we need to do each year in this country with respect to replacing our nation's oil and gas reserves. If you do make changes, I think it is important that you differentiate between industries that have always used partnerships as an integral part of doing business and those who have not. Thank you.

[The statement of Mr. Lollar follows:]

HEARINGS ON THE TAX TREATMENT OF
MASTER LIMITED PARTNERSHIPS (MLPs)
JUNE 30 AND JULY 1, 1987

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

Testimony of Mr. John H. Lollar
President Transco Exploration Company

INTRODUCTION

This Testimony is given on behalf of Transco Energy Company ("Transco"). Transco, with assets in excess of \$4 billion, is a diversified energy company headquartered in Houston, Texas, whose principal operations include natural gas transportation and marketing, oil and gas exploration and production, coal production and marketing and other marketing and energy ventures. Transco's common stock is listed on the New York Stock Exchange under the symbol E.

Transco is a general partner of Transco Exploration Partners, Ltd. ("TXP"), a Texas Limited Partnership, formed to succeed to the oil and gas exploration and production business being conducted by Transco Exploration Company ("TXC"), a wholly-owned subsidiary of Transco, primarily offshore Louisiana and Texas in the Gulf of Mexico. On July 13, 1983, TXC contributed all of its assets and business to TXP, and TXP assumed substantially all of TXC's liabilities, in exchange for interests in TXP. Immediately thereafter, limited partner interests in TXP were offered and sold to public investors in an underwritten primary offering. Transco Exploration Partners, Ltd. is listed on the New York Stock Exchange under the symbol EXP. There are currently approximately 75 million units outstanding of which approximately 54 million units (73.2%) are held by Transco and 21 million units (26.8%) are held by approximately 70,000 unitholders. Based upon the current market value of limited partner interest in TXP (approximately \$13.25 per unit), TXP has a market value of approximately \$1.0 billion.

The Subcommittee has expressed its intent to: (1) review the application of current law rules to MLPs with particular emphasis on the impact of the Tax Reform Act on the use and nature of master limited partnerships; (2) analyze the reasons for any changes in taxpayer behavior due to the 1986 Act and the implications such changes may have regarding projected revenue collections from the corporate sector and; (3) focus on the application of Code Section 7701 classification regulations to MLPs. I have assumed that the Subcommittee's definition of an MLP is a limited partnership whose partnership interests are traded on a major stock exchange. My testimony is intended to demonstrate to the Subcommittee that no change in the current tax treatment of MLPs is warranted.

POLICY CONSIDERATIONS

Decisions affecting tax policy should not be made without considering the total ramifications of such decisions. Partnerships have, traditionally, been utilized by the energy industry as flexible and cost-efficient financing vehicles. Any change in the tax treatment of MLPs will have an adverse impact upon the ability of companies, particularly in the natural resources area, to effect capital formation. This change would come at a time when the natural resource industries need assistance. The oil and gas industry has been in an economic depression for several years and for some time has been voicing its concern over the national security implications of the resulting decline in domestic drilling and decline in domestic production and reserve additions.

The Department of Energy (DOE) has recently echoed the industry's concern. The DOE recently released its Energy Security Study which clearly warns of the danger posed to the United States by the shrinkage of the domestic oil and gas industry and our increasing reliance on imported oil. This study projects

Hearings On MLPs
June 25, 1987
Page Two

that U.S. oil imports could rise from the average of 5.3 million b/d last year, about a third of consumption, to 8-10 million b/d, half of expected consumption, by the mid - 1990's. Currently U.S. oil imports account for nearly 40% of all energy supplies. Some industry members are forecasting that the U.S. will be importing more than 50% of its crude oil requirements in three to four years as compared to the DOE's mid - 1990's forecast. Domestic crude oil production dropped approximately 800,000 barrels per day in 1986. A further drop of 500,000 b/d has been forecast by Chevron Corp., while demand is expected to increase by 200,000 b/d.

The United States Energy Association also recently released its report (a copy of which is attached hereto) which predicts that the U.S. is approaching another energy crisis that will threaten national security and crush the U.S. economy. The National Petroleum Council and the American Petroleum Institute have also issued similar reports. All of these studies state that growing oil imports are a severe problem and that steps should be taken to increase U.S. energy security.

In addition to the above mentioned reports concentrating on imported oil, the Gas Research Institute's 1986 Baseline Projection of U.S. Energy Supply and Demand indicates that there could be spot shortages of natural gas during peak demand periods by as early as next winter. A study performed for Transco Energy Company also indicates that by the early 1990's the "Gas Bubble", or excess deliverability, will disappear.

The forecasts of increased imported oil and GRI's forecast of natural gas spot shortages are attributable to the fact that fewer wells are being drilled today. During the week of June 15, 1987 there were only 814 drilling rigs in operation in the United States. This contrasts with 1,137 drilling rigs operating a year ago and 4,520 in December, 1981.

How are we going to get more wells drilled in the U.S.? According to Energy Secretary John Herrington, the Energy Security Study shows the need for initiatives to strengthen the U. S. oil and gas industry and to reduce our growing dependence on insecure imported oil. Although the DOE study does not make policy recommendations, Secretary Herrington in a letter to President Reagan, urged the administration to consider several tax policy alternatives to assist the oil and gas industry. Presently, legislation has been introduced providing for tax incentives aimed at bolstering domestic oil and gas production. While it is important to explore new ways to assist the industry, it is equally important to preserve those incentives which already exist. Over the past 10 years, more than \$27.5 billion has been raised by the oil and gas industry through public and private offerings of limited partnerships. In recent years, much of this new money has been raised through MLPs, which have proved to be a highly cost-effective vehicle for attracting capital to the energy industry. In the current environment, the domestic natural resources industry simply cannot afford to lose this vital source of equity capital for our exploration efforts.

IMPACT OF THE TAX REFORM ACT OF 1986

In the wake of the Tax Reform Act of 1986, there have been several articles promoting the widespread use of MLPs as a substitute for incorporating a business. These pronouncements are very similar to those that appeared in 1983 suggesting that MLPs would soon lead to the "Disincorporation of America". Obviously, such disincorporation of America did not occur, and it is unlikely that the 1986 Tax Reform Act will have any greater impact on the structure of corporate America.

- In a recent article entitled A Pragmatic View of Corporate Integration, Mr. Robert J. Leonard, Chief Counsel to the House Ways and Means Committee, indicated that certain provisions of the Tax Reform Act of 1986 may, in the aggregate, have the effect of promoting disincorporations of certain existing entities or, as another expression of the phenomenon, failure to incorporate by certain start-up businesses.

This supposed trend toward disincorporation is attributed to: (1) a shift of \$120 billion (over five years) in the tax burden from individuals to corporations; (2) the maximum rate differential between individuals and corporations; (3) the alternative minimum tax applying to corporations only; (4) repeal of the Capital Gain differential; (5) repeal of the General Utilities Doctrine; (6) the toll charge

Hearings On MLPs
June 25, 1987
Page Three

on conversion to S Corporation status; and (7) the present statutory and regulatory regime for partnerships under Subchapter K.

At least in the oil and gas industry, it is apparent that neither the Tax Reform Act of 1986, nor the availability of the partnership entity (including MLPs), will lead to the failure to incorporate new ventures. It is equally unlikely that there will be widespread disincorporation of companies involved in the oil and gas industry. As a matter of fact, the Tax Reform Act of 1986 will greatly reduce the number of new ventures in oil and gas.

Although limited partnerships have long been used as a start-up vehicle for oil and gas ventures, such use has been virtually eliminated by the passive loss rules contained in the Tax Reform Act of 1986. Natural resource MLPs and other limited partnerships have traditionally represented investment vehicles suited primarily to the needs of individual investors. While a privately placed limited partnership usually required an individual with substantial economic worth, an MLP is available to an investor of modest means. These investors are attracted to MLPs because of their relatively high cash distributions which produce a favorable after-tax yield. It is highly unlikely that any start-up business will initially have sufficient amounts of cash available for distribution to its investors. In addition, a start-up business could not assure any potential investor of future availability of cash for distribution. This inability to initially make cash distributions, coupled with the future uncertainty of the business, will make most start-up MLPs unattractive to individual investors. Furthermore, start-up MLPs cannot look to institutional investors for their capital requirements. There is very little participation by institutional investors in MLPs due to the Unrelated Business Taxable Income (UBTI) concerns.

As I stated earlier, the limited partnership entity has historically been utilized in the natural resource industry as an important means of raising capital for oil and gas exploration and production. Typically in the oil and gas industry, the start-up of a new venture involving individuals, entailed an operator establishing a drilling program with several oil and gas prospects structured as a limited partnership. Units in the limited partnership were then sold through a private placement. Initial drilling and development costs were deductible by the individual. The individual investor would report taxable income if and when the limited partnership became profitable. The passive loss rules of the Tax Reform Act of 1986 in essence would require that the individual become a general partner in order to obtain any tax benefits on the initial drilling of wells or any tax benefit if the drilling venture was not successful. It is highly unlikely that a large number of small investors would be willing to risk their personal worth by becoming general partners in a start-up oil and gas limited partnership or MLP. Furthermore, start-up oil and gas ventures typically generate very little cash for distribution, which would make them doubly unattractive for the small investor. The effect of the Tax Reform Act on oil and gas limited partnerships is reflected in Robert A. Stanger's recent report which indicates that sales of oil and gas drilling partnerships have fallen by 76% in the first quarter of 1987 and only one oil and gas MLP has been formed in 1987.

Secondly, the concern that current tax treatment of limited partnerships (including MLPs) will result in the disincorporation of existing businesses is equally unrealistic when applied to the natural resource industries. The few examples of such transactions which have taken place in the past indicate that they were very expensive even when they enjoyed the benefits of the General Utilities Doctrine. For example, the liquidation of one natural resource corporation into an MLP incurred a total tax cost of approximately \$120 million. However, it is doubtful that any existing corporation involved in a natural resource industry would liquidate from corporate form and convert their operations to a limited partnership today. Even though such instances may have occurred prior to the Tax Reform Act of 1986, the repeal of the General Utilities Doctrine in the Tax Reform Act of 1986 makes this possibility in the future very unlikely. The tax costs of disincorporating an existing business in a public company through a complete liquidation into an MLP would be prohibitive. The liquidation of the company into an MLP would generate taxable capital gains at the shareholder level coupled with recapture and capital gain tax at the corporate level. For example, the much publicized proposal of Community Psychiatric Centers to liquidate into an MLP was ultimately voted down by its Board of Directors. One of the reasons for not converting to an MLP was the significant tax cost of the proposed transaction.

Hearings On MLPs
June 25, 1987
Page Four

IMPACT ON REVENUE COLLECTIONS

We believe the use of MLPs in the oil and gas industry has not appreciably decreased revenue collections, but instead may have increased such collections. We also believe that this will continue to hold true in the future. We are not aware of any start-up oil and gas venture initially structured as an MLP. The existing MLPs have been formed primarily either through what is called a "roll-up" or a "roll-out". A roll-up is a consolidation of several smaller non-traded limited partnerships into a publicly traded MLP such as the Apache limited partnership. In a roll-out MLP, a specific segment of a company is contributed to a partnership and the partnership units are sold in a primary or secondary offering. A third alternative, already mentioned, is the conversion from corporate form to an MLP by means of a liquidation.

The roll-up of several smaller non-publicly traded limited partnerships into a publicly traded MLP does not have an adverse impact on revenue collection. This is because the tax treatment accorded the MLP and limited partners are the same before and after the consolidation of the smaller limited partnerships. However, the fact that the partnership interests are publicly traded results in current revenue increases attributed to tax on recapture income each time a unit is sold and tax on possible appreciation in the value of the units. A roll-out involving a secondary offering results in substantial recapture and capital gains tax payments being made by the corporation.

TXP's formation would be considered a roll-out transaction. Transco Exploration Company, a subsidiary of Transco, contributed all of its assets and business to TXP and limited partner interests were offered and sold to public investors in an underwritten primary offering. Initially, 55 million units were issued with Transco retaining 88% of such units. Currently, there are 76 million units outstanding with Transco owning approximately 54 million or 73.2%. The increase in the number of units is attributable to a second underwritten primary offering in which 4 million additional units were issued. The remaining additional units were issued in exchange for Transco's retribution of all its cash distributions. It is important to note that the formation of TXP continued to expose most of the business to corporate taxation. Initially, 88% of TXP's income or loss was included in Transco's consolidated return and currently 73.2% is so included. Many other large MLPs formed as roll-outs are also subject to corporate taxation to a large degree because the sponsoring company has retained a very significant ownership interest in the MLP. Approximate corporate sponsor ownership of eight very large MLPs are as follows: Diamond Shamrock Offshore Partners, Ltd., 81.2%; Enserch Exploration Partners, Ltd., 87%; Freeport McMoran Resources Partners, Limited Partnerships 73%; Freeport McMoran Energy Partners, Ltd., 78%; Santa Fe Energy Partners, 80.7%; Sun Energy Partners, L.P., 97.4%; Transco Exploration Partners, 73.2%; Union Exploration Partners, 95%.

The use of debt by corporations is a method of reducing the income tax liability through interest deductions. In general, MLPs have very little debt as compared to corporations. The funds received by the MLPs through their underwritings are usually utilized to reduce existing debt or are used in current operations which reduce the requirements for incurring debt. The eight large MLPs mentioned above have raised approximately \$1.5 billion in their underwritings, \$997 million being utilized to reduce existing debt and \$456 million used for current operations. I do not believe that revenue collections were decreased due to these debt reductions and lessened requirement for debt.

In order to increase the yield being earned by their shareholders, many sponsoring companies (including Transco), distributed partnership units as dividends. Such dividends, amounting to approximately \$544 million, have been distributed by sponsoring companies of six of the above mentioned MLPs. This dividend income would probably not have been distributed if the sponsoring companies had not formed MLPs. This dividend income surely increased Treasury's revenues significantly. The trading of the partnership units of MLPs has also generated Treasury revenues due to the tax on recapture income recognized on each trade and possible appreciation in value of the units.

Even though a precise calculation cannot be made on the revenue impact of MLPs in the natural resource area, indications are that the revenue impact should not be negative.

Hearings On MLPs
June 25, 1987
Page Five

SECTION 7701 CLASSIFICATION OF MLPs

In 1935, the United States Supreme Court focused on the definition of association and identified, for the first time, the factors which should be looked to in distinguishing between corporations and other business enterprises. Basically, that decision, Morrissey v. Commissioner, 296 U.S. 344, 56 S. Ct. 289 (1935), established the four criteria to be free transferability, continuity of life, limited liability and centralization of management. Thus, transferability of interest was a factor but, significantly, far from being the only factor mentioned. In fact, the Morrissey court placed less emphasis on the transferability factor than it did on the others.

The applicable Treasury regulations promulgated under Section 7701 of the Internal Revenue Code (the "Code"), primarily in response to the decision rendered by the 9th Circuit in United States v. Kintner, 216 F. 2d 418 (9th Cir. 1954), lists the same four factors in distinguishing between a partnership and a corporation. Under the regulations, where a partnership has a preponderance of these factors, such partnership will be treated as an association taxable as a corporation.

The current long standing criteria for imposing corporate tax treatment should not be disregarded merely because the partnership interests are traded on a major stock exchange. The legal distinctions between partnerships and corporations were thoroughly discussed in hearings held before this Subcommittee on June 9, 1986. I would like to quote the more important distinctions presented by Mr. Barksdale Hortensine of the law firm of Andrews & Kurth in testimony before this Subcommittee:

(1) Limited Liability -

Many commentators have expressed the view that limited liability is the corporate privilege that most justifies the imposition of a corporate tax and should continue to be the most significant factor relied on in distinguishing corporations from limited partnerships. All of the PTPs formed to date have been structured to insure that at least one general partner has substantial assets, exclusive of the general partner's interest in the PTP, exposed to claimants of the PTP. To my knowledge, no PTPs have placed any reliance on the 'dummy' test contained in the current regulations to establish the absence of limited liability but, instead, have relied on the substantial assets test. In a number of cases, the assets of a parent company which had previously been unexposed to activities insulated through subsidiary corporations become exposed to claims arising from such activities when they are contributed to the PTP.... A shareholder basically is given unqualified limited liability. A corporation is generally free to distribute funds to a shareholder out of earnings and capital (subject to insolvency limitations) with no attendant obligation on the shareholder to return them. A limited partner, on the other hand, has general liability, to the extent that a distribution constitutes a return of his initial investment, to any partnership creditor whose claim arose prior to the distribution (regardless of solvency of the partnership at the time of the distribution). A limited partner generally remains liable for the return of a distribution even after the disposition of his partnership interest. Even a transferee of a partner will become liable to the same extent as his transferor if the transferee reasonably could have ascertained the existence of such liability at the time he acquired the interest.

(2) Lack of Perpetual Existence -

Another substantive distinction between a partnership and a corporation is a partnership's lack of corporate perpetuity. Unlike shareholders, partners must live without the certainty of an uninterrupted business form. Superficially, continuity of life, at least as determined by the potential for dissolution as opposed to termination, may appear as only a legal nicety. In a partnership, however, the death, removal, dissolution, bankruptcy or other withdrawal of the last remaining general

partner will result in the dissolution of the partnership. No such interruption in the continuity of a corporation results from withdrawal of directors or management. Following a dissolution, partners may generally avoid a winding-up of the partnership by a majority of the partners electing to continue with a new general partner. Such vote to continue is materially different from the vote otherwise required to dissolve a corporation. The practical likelihood of a PTP, dissolved upon the bankruptcy of the general partner, being reconstituted and continued by the partners is subject to substantial doubt. Thus, dissolution constitutes a meaningful consideration to anyone faced with selecting an entity for a particular activity.

(3) Centralized Management -

Centralization of management is another factor often relied on in distinguishing partnerships from corporations. Although a cursory review of this characteristic might suggest that every limited partnership possesses a degree of centralized management, a substantive distinction does exist between the degree of centralization found in corporations and that found in limited partnerships. In the context of a corporation, the standard which has evolved is the 'business judgement rule.' Under such rule, it is presumed that in making business decisions the directors have acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the corporation. Absent an abuse of that discretion, decisions of directors will be respected by the courts. Such rule facilitates the substantial involvement of independent outside directors in public companies.

There is no such protective presumption in the partnership arena for professional managers. The general partner of a limited partnership generally has a fiduciary duty that is characterized as closer to that of the duty of a trustee to his beneficiaries than that of a director to his shareholders. Accordingly, business decisions by the general partner must satisfy the standards of undivided loyalty, scrupulous good faith, fairness and honesty. Moreover, some jurisdictions impose on a general partner the burden to dispel all doubts regarding its conduct, and if it is unable to carry this burden, all doubts will be resolved against it. Although the fiduciary obligations of a general partner to a limited partnership and its limited partners is generally considered subject to change by the partnership agreement, the scope of that concept as it applies to PTPs is unclear. Thus, it is unlikely that disinterested professional managers will play a major role in management of PTPs as general partners.

(4) Free Transferability -

Another characteristic significant to the classification issue is free transferability of interests. To the extent free transferability is unique to the corporate form, it is only because, as a legal matter, a transferee of a shareholder will automatically obtain all the rights and benefits of his transferor. A transferee of a limited partner's interest, on the other hand, will generally only obtain such rights if the general partner consents to his substitution and only upon satisfying the statutory requirements applicable to such substitution. Although prior to substitution the assignee is entitled to all of the economic benefits of ownership, he is not entitled to certain other substantive rights such as access to information and exercise of voting or consent rights. The continuing obligation of an assignor who remains the limited partner of record in respect of his partnership interest to reimburse the partnership for return of capital distributions made to his assignee is uncertain. Thus, a meaningful distinction exists between an owner that has the right to vest in his transferee all rights previously held by the transferor and one who has only the right to assign the economic benefits of ownership. Transferability, therefore, is a characteristic truly intrinsic to corporations that can

Hearing On MLPs
June 25, 1987
Page Seven

constitute a substantive corporate privilege as a legal matter. The current regulations recognize such privilege and appropriately distinguish mere assignability from transferability.

It would not be appropriate to disregard the legal substance of transferability intrinsic to corporations and apply it, instead, as if it turned on the purely extrinsic feature of 'tradeability.' If tradeability relates to the right to assign the economic benefits of ownership for a consideration, such approach is troublesome in that a degree of 'tradeability' potentially exists with every partnership and corporation. On the other hand, tradeability cannot turn on whether interests are traded in an established market. If such were the case, 98 percent of all corporations, the percentage of corporations reportedly not traded in a public marketplace, would be classified as pass-through organizations under an honest application of the consistency principle. Such absurd result is only a natural consequence of straying from state law corporate privileges as the fundamental basis for classifying business organizations. Tradeability no more justifies a distinction between intrinsically identical partnerships than it justifies a distinction between intrinsically identical corporations.

Mr. Roger Mentz, the Assistant Secretary of the Treasury for Tax Policy, also testified before this Subcommittee on June 9, 1986, supporting the taxation of publicly traded partnerships as corporations. His testimony in essence indicated that an entity that is actively engaged in a business enterprise and has a large number of partners that change frequently does not fit into the partnership definition.

Liquidity of a limited partnership, to the exclusion of the other substantive distinguishing factors, should not be the basis for imposing a corporate tax on limited partnerships. One should not ignore factors such as limited liability and centralized management that create important functional differences between corporations and publicly traded partnerships. Mr. Ronald Pearlman, former Assistant Treasury Secretary, testified before the Senate Finance Committee on this issue in October, 1983, stating that extensive study was required prior to adopting such a radical change. He concluded that: "We have serious doubt that after such an analysis one could conclude that the marketability of an organization's equity interests should determine the manner in which the organization is taxed."

CONCLUSION

In summary, there is simply no sound legal or economic theory on which corporate taxation of MLPs can be based. This is particularly so in the case of oil and gas MLPs where such policy would actually frustrate current efforts to bolster domestic production.

Partnerships such as TXP have clearly demonstrated their value to the oil and gas industry as flexible, cost-effective vehicles for capital formation. At a time when Congress is debating measures to deal with the growing tide of imported energy, it would make little sense to compound this problem by impairing the capital formation efforts of our domestic producers.

Furthermore, it is unlikely that the continued existence of MLPs in the energy field will lead either to wholesale reincorporation within the industry or to a rash of start-up ventures structured as MLPs. In the wake of the Tax Reform Act of 1986, any liquidation of an existing corporation into an MLP will generate a prohibitively large tax liability for both the corporation and its shareholders. Start-up energy ventures are unlikely to be structured as MLPs because of their inability to generate sufficient cash distributions to attract investors. The dearth of energy MLPs in the first quarter of 1987 clearly attests to these facts.

Thirdly, a logical case cannot be made for the proposition that existing oil and gas MLPs have diminished the Treasury's revenue. In point of fact, the formation of many of these partnerships, when combined with the public trading and dividending of units, has actually increased tax revenues. It must also be kept in mind that the sponsoring corporations of most of the large oil and gas MLPs continue to hold the vast majority of their MLP units, so that the business continues, for the most part, to be exposed to the corporate tax.

Hearings On MLPs
June 25, 1987
Page Eight

Finally, the existing criteria for imposing the corporate tax have been firmly established for over 50 years. Although transferability has been included in such criteria, it has never been given preeminence over equally relevant factors such as centralized management, limited liability, and limited life. These other factors continue to draw very real legal and economic boundaries between partnerships and corporations, regardless of whether the entity is publicly traded. Such factors should not be disregarded in favor of an arbitrary, mechanical test with no sound theoretical basis.

The blanket imposition of the corporate tax on all MLPs would represent faulty legal and economic analysis. Even worse, it would constitute short-sighted and possibly dangerous policy in the face of another impending energy crisis. Transco strongly urges the Congress to make no change in the present taxation of MLPs.

PJP

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Chairman RANGEL. Mr. Chapoton, it is clear that the panel here represents the natural resource industry. Was your testimony restricted to oil and gas as well?

Mr. CHAPOTON. No, sir. I made it clear to the staff that my testimony would not be related to natural resources.

Chairman RANGEL. Then would you differ with the administration that would want to make changes as relates to MLP's but to exclude natural resources such as oil and gas? You would oppose the administration's position?

Mr. CHAPOTON. I oppose the Treasury proposal to tax MLP's as corporations. I think if you cross that line and start having special rules, I think No. 1, you will be in trouble. The friends of the industry will try to have a special rule or the industry will be in difficulty later because it exposes that industry.

I will concede that there are industries that have traditionally operated in partnership form.

Chairman RANGEL. Do you see as a former member of this administration the complexities of administration that your successor talked about?

Mr. CHAPOTON. There are definitely complexities in dealing with partnerships and huge complexities in dealing with corporations. I do think, though, that they should be addressed. I don't think they apply to the overall question. I don't think they are a deciding factor.

Chairman RANGEL. You dealt with the fact that you don't see any erosion of the corporate base in the future, but your successor was pretty confident that while he didn't see any dramatic changes in the near future, that he sees that this would be a way to go for people to avoid the corporate tax rate, the double tax. You disagree with him?

Mr. CHAPOTON. Mr. Chairman, let me make it clear there will be some—as these gentlemen and I have pointed out, there is an attractiveness to MLP's. One thing is to the extent you raise equity through an MLP the corporate tax is avoided.

There will be some reduction in the growth of the corporate base. But even Treasury's own figures show a very miniscule effect from that. I am confused by Mr. Mentz's statement yesterday talking about a hemorrhage in the corporate tax base. The figures don't support it at all, and the facts, the analysis of what is going on with MLP's, don't support it.

Chairman RANGEL. I went out of my way to find out whether that was Mr. Mentz's point of view or whether it was studied and shared by the administration. So I suspect that somewhere along the line people close to you may have conflicting thoughts about your position.

Mr. CHAPOTON. Mr. Chairman, I think this revenue point ought to be analyzed further because the table attached to the Treasury statement, as I pointed out, going out to the years involved, has a very very small impact from taxing MLP's as corporations. If I may elaborate, you have to draw a distinction, the table does it, but you have to do subtraction to get the right result—draw a distinction between the revenue raised by taxing corporations as MLP's and thereby expanding the corporate base.

Another separate figure is the impact on the passive loss rules from taxing MLP's as corporations. That doesn't have anything to do with strengthening the corporate tax base, but has a lot to do with strengthening the impact of the passive loss rules. But those are separate considerations that ought to be dealt with separately.

Chairman RANGEL. I am picking on you because it is clear that the panelists represent industries that find this as an efficient and effective way for them to raise capital, but on the question of tax policy, you are prepared to say that existing law in your opinion, based on your experience, that this is sound tax policy?

Mr. CHAPOTON. That is correct. I am prepared to say that.

Chairman RANGEL. Mr. Flipppo.

Mr. FLIPPO. Thank you, Mr. Chairman. On your point about the revenue, I understand, Mr. Ballentine, that you have done an extensive analysis of the revenue associated with this issue, have you not?

Mr. BALLENTINE. Yes. I didn't do it personally. I directed parts of it with the staff, yes.

Mr. FLIPPO. I wonder if you might be willing to submit to the subcommittee your findings as well as your analysis and any backup data so that we might have the benefit of your expertise.

Mr. BALLENTINE. It is, and I would be happy to submit that information.

[The following was subsequently received:]

8246X

THE REVENUE EFFECT OF TAXING MLPs AS CORPORATIONS

I. OVERVIEW

Master Limited Partnerships (MLPs) are, in essence, a financing option for obtaining investment funds. Use of an MLP allows a business to sell units in the MLP in order to raise funds for investment. The income on such investments is taxed only once at the level of the individual investor. In contrast, if funds were raised by issuing new corporate shares, double taxation would occur since the income on corporate equity financed investment is double taxed. Consequently, taxing MLPs as corporations will affect revenues (i) if the investment that would be funded by use of an MLP is instead be undertaken and funded by a corporation--including potentially the same business that would have been an MLP--and (ii) if the income from such corporate investment is double taxed.

The second condition necessary for there to be a revenue effect is important because a large share of corporate investment is single taxed, not double taxed. The clearest example is debt financed corporate investment. Since interest payments are deductible at the corporate level, the only tax on the interest component of corporate investment income is the individual tax paid by the lenders to corporations. Over the period 1950-1983, about 44% of net corporate investment expenditures were financed by debt.

The largest single source of funds for corporate investment (48%) is retained earnings. Retained earnings are an equity source of investment funds and, therefore, the income from such investment is double taxed.

However, if funds are not retained they must be paid out as dividends thereby giving rise to current individual taxes on the dividends. That is, current income in a corporation is subject to a double tax, whether or not it is paid out currently. Retaining the income postpones the double tax, but does not reduce its present value. Paying out the income causes the double tax to be paid currently.

The testimony of John E. Chapoton before the House Subcommittee on Select Revenue Measures of the Committee on Ways and Means (July 1, 1987) explains that the cost of capital for investment financed by retained earnings is essentially the same as the single taxed cost of capital for debt. The decision to finance an investment by retaining earnings implies that the future income on that investment will be double taxed, but it also implies that current double taxes are avoided. The net tax burden on the investment financed by retained earnings is only the corporate tax itself. As explained more fully below, the revenue effect of a decision to finance investment by retaining more earnings is first a reduction in revenue, as current individual dividend taxes are reduced, then an increase in future revenues as future dividend taxes are increased.

Corporate investment financed by new share issues results in a clear, unambiguous double tax. By purchasing new shares, individuals commit new funds to the corporations without any current tax saving. The income on the investment is double taxed. Not surprisingly, since new share financed investment bears a high tax burden, only a small portion of corporate investment (8%) is financed by new shares. Clearly, revenues are increased when more investment is financed by new corporate share issues.

II. THE REVENUE ESTIMATING MODEL

As the above discussion made clear, the revenue effect of taxing MLPs as corporations depends on how the investment that will be in corporate form, but would have been funded by an MLP, is financed. Before specifying the detail of the revenue estimating model, two other issues must be addressed.

First, due to the repeal of the General Utilities Doctrine and the full taxation of nominal capital gains, only new investment and how it is financed is relevant for the revenue estimate. That is, under current law a full double tax must be paid if existing corporate assets are transferred into partnership form. In general, this full double tax will at least offset in present value the tax savings from converting the existing corporate equity from double taxed investment to single taxed investment.

As a result, the revenue effect from taxing MLPs as corporations is based on the amount of new investment that will be converted into corporate form, instead of being undertaken by an MLP. This brings up the second issue to be dealt with before explaining the estimating model. If MLPs are taxed as corporations, not all investment that would have been undertaken by MLPs will be undertaken by corporations. Other partnership forms can be close substitutes for an MLP. These other partnerships can be quite large and their shares of interest can even be traded. As a result, if MLPs are taxed as corporations, many ventures that would have been undertaken by an

MLP might be undertaken by a partnership not in MLP form. Clearly no revenue effect arises from shifting some investment from being undertaken by an MLP to being undertaken by some other type of partnership.

Based on the foregoing, the model begins with the projection of the path of a new investment that would have been undertaken by MLPs. The model assumes that, with no change in the tax laws, MLP investment will grow rapidly. Specifically MLP investment is projected to rise 40% in 1988, 35% in 1989, 30% in 1990, 25% in 1991, and 20% in 1992. As just mentioned, if MLPs are taxed as corporations, a portion of this investment will shift to other partnership forms. There is no reason, however, to expect that portion to grow over time, therefore over 1989-1992, the investment that will be in corporate form due to the law change will grow at the same rate as overall MLP investment over that time period. This is the investment stream that is the basis for the revenue estimate.

The key issue for the revenue estimate is how this additional corporate investment will be financed. The model uses three different sectors, oil and gas, real estate, and "other." It is assumed that the additional corporate investment in each sector is financed using the same debt/equity ratio as is found in the respective sectors. Based on I.R.S. statistics, the debt/equity ratio for the oil and gas sector is assumed to be .99 (i.e. there is about \$1 of debt for each \$1 of equity), in the real estate sector it is assumed to be 2.81 and in the "other" sector it is 1.02. MLP real estate investment is considerably larger than that of the other two sectors. As a result, the overall estimate is that well over half of the additional corporate investment will be debt financed.

Since debt financed investment is single taxed at the individual level, there is no revenue effect due to the shift to corporate debt financed investment from MLP investment. A revenue effect must come from the MLP investment that shifts to corporate equity financed investment. A simple example will help to explain how the model deals with this important case.

Suppose that \$100 of new investment that would have been MLP investment instead becomes corporate equity financed investment. There are two sources of corporate equity finance, retained earnings and new stock issues. Historically, new stock issues have accounted for only about 20% of equity finance and retained earnings accounted for 80%. Using those figures, the corporate sector will issue \$20 of a new stock and will retain an additional \$80 of current earnings. The immediate effect of the increased retentions is a loss of revenues because the \$80 of additional retentions lowers dividends by \$80 thereby lowering taxes on dividends by \$22.40 (at a 28% tax rate).

Working in the opposite direction to this loss of revenues is the additional taxes due to the double taxation of the income from the \$100 equity investment. Assuming a 10% pre-tax return, the \$100 of equity investment generates \$10 of pre-tax income and \$3.40 of corporate taxes. If 50% of after-corporate-tax income is paid out as dividends, the \$6.60 of corporate income after taxes gives rise to \$3.30 of dividends, which, when taxed at a 28% rate, results in \$.92 in individual dividend taxes. Further, the \$3.30 of retained earnings raises the value of the corporation's stock by that amount. If 10% of stock is sold each year, this results in \$.09 in capital gains taxes (10% of \$3.30 taxed at 28%).

The total tax on the income from this investment in the first year is \$4.41; \$3.40 of corporate taxes, \$.92 in dividend taxes, and \$.09 in capital gains taxes. If the investment had been undertaken by an MLP, the \$10 of investment income would have been taxed once at a 28% rate giving \$2.80 in taxes. The extra tax on the income from the investment is, therefore, \$1.61 (\$4.41 less \$2.80).

In the first year, then, the overall effect on revenues in this simple example is a net loss of \$20.79. Revenues fall \$22.40 due to the reduced dividends and rise \$1.61 essentially due to the double taxation of the income from the investment.

If \$100 of additional investment occurs in the second year and it too is divided into \$20 funded by new share issues and \$80 from additional retentions, then the revenue loss will decline. This is because the revenue loss due to lower dividends still is \$22.40, but the revenue gain from the double taxation grows to about \$3.30 since income on both the first year investment and the second year investment is doubly taxed. If \$100 of additional investment occurs every year, the revenue loss will eventually become a revenue gain.

The above example was purposefully simplified to highlight the importance of the two sources of equity finance, retained earnings and new share issues. In the actual model used, only 20% of additional corporate equity investment comes from retained earnings as opposed to 80%, which is the historical ratio. The remaining 80% is assumed to come from new share

issues. These ratios were chosen deliberately to be conservative. The higher is the retained earnings share, the larger will be the revenue loss in early years. In addition, since new share issues are the most heavily taxed source of finance, it should be expected that corporations will largely substitute use of an MLP for new share issues. Given this factor, the assumption that only 20% of the additional equity finance comes from retentions is a reasonable, conservative estimate.

The actual model also assumes that the before tax yield in the three sectors fluctuates with the prime interest rate. The prime rate series used comes from the Data Resources Institute long range forecast in the winter of 1986-87. Using information published in the March 1987 Stanger Report, it was calculated that in the oil and gas sector the pre-tax yield is slightly below the prime rate, in the real estate sector it is about 25% above the prime rate, and in the "other" sector it is equal to the prime rate. Also based on information from the March 1987 Stanger Report, in the oil and gas sector it is assumed that 80% of financial income is tax sheltered, 50% in the real estate sector is sheltered, and 30% in the "other" sector.

These parameters dealing with pre-tax rates of return and the fraction of income sheltered determine the income that would have been taxed at the partnership level but instead will be taxed at the corporate level. To determine the revenue from double taxation, it is also necessary to know the dividend payout ratio in each sector. Based on IRS Statistics of Income data, the payout ratio in the oil and gas sector was set at 55%, in the real estate sector it was set at 50% and in the "other" sector it was set at

37%. Finally, data indicate that about 35% of corporate securities are held by tax exempt entities or otherwise did not give rise to reported taxable dividend income.

III. SPECIFIC RESULTS

Based on the data described above, the model gives the following estimates for the change in fiscal year receipts from taxing MLPs as corporations assuming (i) that existing MLPs are grandfathered and (ii) that the income of MLPs is treated as portfolio income while the losses are passive.

The estimate is broken down into two components--the revenue gain from additional double taxation and the revenue loss from increased retentions.

Revenue Effect of Taxing
MLPs as Corporations
(Existing MLPs Grandfathered
and MLP Income Treated as Portfolio Income)
(\$ in millions)

	<u>Fiscal Year Receipts</u>				
	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Double Taxation Effect	4	16	31	53	84
Retained Earnings Effect	<u>-23</u>	<u>-53</u>	<u>-61</u>	<u>-67</u>	<u>-70</u>
Net Effect	-19	-37	-30	-14	14

Mr. FLIPPO. That would be very helpful. If I might ask our panelists—Mr. Cain, could you tell me something about what percentage of debt to equity that your partnership has or Mr. Neafsey?

Mr. NEAFSEY. I can tell you. Our partnership has roughly \$1 billion in debt in the total structure of about a \$4 billion enterprise, so it is about 25 percent.

Mr. FLIPPO. How would that compare to a nonmaster partnership?

Mr. NEAFSEY. That would be typical of the oil and gas industry, so there is no essential change in terms of debt to equity structure based on a partnership or not.

Mr. FLIPPO. Could you tell us what alternative structures that you considered when you finally decided to form a master limited partnership and why did you reject some of the other structures?

Mr. NEAFSEY. There really are only three generic options that were available to us. We could have raised additional money in the debt market. That would have been more tax inefficient or tax efficient depending on how you look at it, but we rejected that because we felt that the risk/reward ratio should not compel us in the direction of adding additional debt.

We looked at the equity market, selling additional common shares of stock in the Sun Co., and we rejected that out of hand as the stock price at that time was too low; the dilution that our existing shareholders would have suffered would have been too great to go forward with that kind of an offering.

So we searched for a hybrid and found that a master limited partnership was an ideal hybrid whereby the risk-reward characteristics of that particular financing tool were ideally suited to the kind of exploration and development projects that we had in mind.

All of these calculations in terms of Treasury losses are compared against the equity alternative, raising new funds through the equity market. I would submit that in our case that was absolutely dismissed out of hand. That was not a real alternative and I would guess in most of the other cases it was not an alternative as well, so it is a bit of a straw man.

Mr. FLIPPO. Our panelists have mentioned liquidity as a very important factor in the use of this capital. Do you have more liquidity under this approach than you would under a corporate approach?

Mr. NEAFSEY. The prime vehicle for liquidity really deals with the investor, not with the corporation.

Mr. FLIPPO. Does he have more?

Mr. NEAFSEY. Absolutely. If you take two investors, one who has an opportunity to invest in a registered partnership, but not a publicly traded partnership, and say that investor puts \$1,000 or \$100 into that investment, typically he has an option to get his money back out except through the production operations and the cash flow which will come out of that partnership over a long period of time.

If through death or necessity or a variety of reasons that investor would like to cash in that investment, he is locked in and will have to take a severe discount in order to get any amount of his principal back. In the case of the publicly traded partnerships he can invest more or invest less. He can cash in or cash out every day on the stock exchange.

It is just a much fairer system for the little guy.

Mr. FLIPPO. So it makes it more attractive to the little man.

Mr. NEAFSEY. Absolutely.

Mr. FLIPPO. Let me ask Mr. Lollar, if the master limited partnership was not available what other structure or forms would you be looking at? Could you—do you have any other available that you like—

Mr. LOLLAR. Really the formation of our master limited partnership went back to 1983 and as I said, we needed something unusual really to attract an investor's attention to an oil and gas deal at that particular time. There wasn't any substantial interest in oil and gas investment at that time. We thought the MLP route really provided an unusual opportunity.

As far as deals that we are doing today with our unit price selling where it is right now, we are really not in the public market right now. We are forced to go back and work privately. We have just put together about a \$135 million deal. It was signed yesterday, with three other investors that will focus on exploration in the Gulf of Mexico, but that is a private partnership.

Mr. FLIPPO. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. Mr. Chapoton, I thought the chairman had made a very important observation to open our meeting. He slipped away right now, but if I recall correctly it was basically the discussion that these MLP's had begun to look like corporations.

Help us with that a little bit. It strikes me that there is some differences between an MLP and a corporation in the way we recognize income, the ultimate ease of transferability, administration and so on. Can you shed some light in those areas as to the difference between the two?

Mr. CHAPOTON. I can try, Mr. Brown. I think there are a couple of respects. One, I think MLP's look and act like corporations in many respects. There are differences between corporations and partnerships, tax and nontax, and so it really depends on your viewpoint. I think the shares are basically transferable; that is the point. The main characteristics I really point to that do flow primarily from a tax standpoint from the difference in tax treatment: two things happen if a venture decides to raise capital, and is considering corporate form, which would primarily be debt and not equity capital. They could raise capital as debt within a corporation, or through a MLP.

If the venture decides to go the MLP route, it would have to distribute more in earnings than it otherwise would and, two, doing so forecloses part of the market. Mutual funds are not interested. Foreign investors and institutional investors are not interested. The venture also must undertake the significant costs of administering an MLP that do not exist in the corporate form. So there are differences and similarities as well.

Mr. BROWN. How would you compare a MLP and a subchapter S? Obviously there is a difference in the number of owners, but in terms of the tax treatment?

Mr. CHAPOTON. The basic differences are non-existent other than the publicly held aspect.

Mr. NEAFSEY. May I add one point on the difference between a corporation and a master limited partnership? The master limited partnership allows for these investors to invest directly in a very limited area of activity, for example, in the domestic oil and gas business or the search for reserves.

If you invest in a company you have an investment across the board, an investment in refineries, in tankers, in pipelines, in petrochemical activities, in exploration activities, in international ventures. It is an across-the-board activity. If on the other hand, your investment preferences and the need of the industry happen to be such that you need to take a rifle shot and you would like to be a direct participant in domestic oil and gas activities, the search for and production of oil and gas in the United States, this provides that kind of delimiting investment vehicle, which I think is a very important capital-raising tool.

Mr. BROWN. There is nothing in the law that stimulates that; that is just a function of how the industry has grown up?

Mr. NEAFSEY. That is correct.

Mr. CAIN. If I may add another point, there is a certain liability factor, too, with the partners. If creditors, for example, there could be a recall of distribution to meet certain creditor calls in regard to a master limited partnership that would not be possible in corporate form, too.

Mr. BROWN. You are talking about a limited liability that goes—people-to-people beyond the general partner?

Mr. CAIN. That is correct.

Mr. BROWN. Can you bring us up to speed on that—because I am not familiar with that. I thought we were talking about a limited partnership in all the MLP's.

Mr. CAIN. If there were financial difficulties within the partnership and if the last distribution had been made that could be recalled by creditors is my understanding. If that were the—if the partnership was suffering financially, difficulties at that point—so there is a liability of that distribution with the limited partnership.

Mr. BROWN. Is that the same kind of thing a bankruptcy court can do with the payments you have made?

Mr. CAIN. I don't know. I wouldn't be that familiar with corporate law, but I would think in the case there is a protection sell of the stockholders in a corporate form, that there is not that specific protection within the master limited partnership.

Mr. BROWN. Mr. Chapoton, you made a point that what we are looking at here in the way of a change probably focuses more on new capital ventures than on the disincorporation current corporations into MLP's.

Mr. CHAPOTON. Yes.

Mr. BROWN. I assume that is because of repeal of the *General Utilities* doctrine because repeal of the doctrine made it a taxable event on the corporate level to distribute assets?

Mr. CHAPOTON. There are two factors in the 1986 act. One is a repeal of the *General Utilities* doctrine so that if a corporation decides to liquidate and recast itself as an MLP, it would have to pay the corporate tax on any untaxed appreciation at the corporate level. In addition, the shareholders would have to pay tax on the distribution and whereas in 1986 that tax at the shareholder level

would have been 20 percent, today it is at the full income tax rate applied to dividends.

Mr. BROWN. Is there a portion of these assets that still could come out? Say we have an asset inside a corporation where the corporate basis is roughly equal to its fair market value. Could that come out of the corporation without tax?

Mr. CHAPOTON. If there is no appreciation, there is no untaxed appreciation. It can come out without tax at the corporate level because there is no gain to tax at the corporate level. There will be tax at the shareholder level.

Mr. BROWN. What if that is exchanged for the asset is roughly equivalent to the market value of the asset? Could it then come out without tax at either level?

Mr. CHAPOTON. If you had complete liquidation at the corporate level, yes.

Mr. BROWN. What about a partial liquidation?

Mr. CHAPOTON. In most cases an attempt like that, a partial liquidation, I believe, would be treated as a dividend and to the extent that the company had earnings and profits, there would be a tax at the corporate level.

Mr. BROWN. One more question—Mr. Cain, you mentioned that MLP's were somewhat unique and different in that it was somewhat costly to administer them and that there were special reporting procedures?

Mr. CAIN. When you are dealing with an MLP you are putting together a great many different revenue producing wells of which we own fractional percentages in those wells, as the industry does, and you also have in our case 50,000 investors, each of them earning their proportionate share of both any sort of tax losses or gains from those individual wells, as well as revenues.

So the mere process of keeping track of that has required an extremely complex and expensive system to develop. I think it was good to note as a result of what Treasury testified back in 1983, I believe it was, in Senate hearings, Senate Finance Committee hearings that they felt that there was probably less abuse at that time in master limited partnerships than there were in other types of partnerships or other investment opportunities simply because the requirements were so great that it required the reporting mechanism was so articulate that there was little chance for abuse within the system.

Mr. BROWN. The oil and gas industry has always been blessed with unbelievable complications, but it strikes me that that affects corporations as well as partnerships. What is unique about an MLP in terms of reporting?

Mr. CAIN. The fact that each one of those 50,000 limited partnerships has a piece of each action that takes place within that master limited partnership, so each expense or each cost or each tax advantage or disadvantage is passed on, in fact, to the individual unit holder. So we are breaking down, in fact, the whole—

Mr. BROWN. You have to break out each investment separately?

Mr. CAIN. Yes, and then of course provide the necessary reports at the end of the year for tax purposes that deal with that, not only for the Federal level, but for each state as well that we work in.

Mr. BROWN. How do you handle the fact that different partners have a different basis?

Mr. CAIN. I would certainly—let me get back to you on that question if I may.

Mr. BROWN. That would be nice to have in writing for the record.

Mr. CAIN. We will respond to that question in writing.

Mr. CHAPOTON. I think the answer is "very carefully."

Mr. NEAFSEY. It is very complex and very conservative.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. FLIPPO. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. I would like to address a few quick questions to Mr. Ballentine and Mr. Chapoton.

I would like you to put Treasury's position into a historical perspective for the committee and for those of us who did not serve on the committee during the tax debate or in 1983. I understand that hearings were held and this issue was debated. The proposal was proffered by Mr. Mentz and his proposal was rejected during the tax debate is that correct?

Mr. CHAPOTON. The question came up in 1983, and I have not recently reread the testimony, but Mr. Pearlman, who was at that time deputy assistant secretary, presented the testimony. The Treasury opposed taxation of a broader classification of partnerships as corporations.

I might also add that the question has come up several times to the Treasury about whether you should do something that would have the effect of expanding the double tax on corporations. Three things have come up recently. One is the taxation of large partnerships publicly traded or otherwise; two is the taxation at the corporate level of distributions of appreciated assets of corporations—an example, the royalty trust case—and, three, repeal of the *General Utilities* doctrine.

The only time until now that the Treasury has supported strengthening the corporate tax was on the dividend of appreciated property, that is the royalty trust situation. The Treasury opposed expanding it to the *General Utilities* doctrine, an expansion of the corporate tax to large partnerships.

Mr. ANDREWS. In 1983 Treasury was here testifying opposed to taxing this kind of transaction. In the tax debate they were for imposing tax on master limited partnerships. What would be your conjecture after Mr. Mentz is gone as to the position of Treasury in 1987 and 1988?

Mr. CHAPOTON. I do not know, Mr. Chairman. It does seem to me in the last year they have been consistent. They proposed taxing MLP's a year ago and again yesterday.

Mr. ANDREWS. They were consistent in 1983, in 1986 and they will be consistent in 1988. We are not sure what their subsequent opinion will be.

Mr. CHAPOTON. Maybe they will see the light as a result of these hearings.

Mr. ANDREWS. There was testimony yesterday that since 1981, 126 or so master limited partnerships have been formed. There was testimony from Mr. Mentz that this huge growth should cause the committee great concern. About 38 or so of that 126 would be defined as natural resource MLP's.

I am very curious about their proposition that we make some natural resource exclusion in the law if we make a change, and I am curious what you two gentlemen in particular think is good tax policy. Does it make good tax policy sense if Treasury is right, to then cash out an exclusion for industries like oil and gas and not treat partnerships, really State partnerships, in the same view?

Mr. CHAPOTON. I stated, I believe, before you got here, Mr. Andrews, that on that point I think it is difficult to justify—the principal justification which has some merit, certainly is historic, in which event I think you would talk about oil and gas and real estate, primarily. But then—I hasten to add, and these gentlemen may disagree—if you look solely at the tax policy, this is another method of financing and if it is available to a particular industry, that industry will have a method of financing that other industries don't have, and so those will be the considerations.

Mr. ANDREWS. That brings me to another issue, the level playing field argument. I wonder if you would address that issue. Have we set up a system now that makes it inequitable, if we leave MLP's in place as they are today? Is it unfair?

Mr. CHAPOTON. The answer—I addressed that in some detail in my testimony. The answer is that there is inequity in the tax system any time you have some capital that is double taxed and some capital that is single taxed. That is going to exist wherever you draw the line. The point is that if you expand the double tax system beyond the portion of the capital of the United States that is subject to double tax, you harm and do not help neutrality.

I do not see an answer to that assertion. You harm it. You do not help neutrality, because the norm in this country in this tax system, is not double tax. The norm is single tax or indeed less.

Mr. BALLENTINE. I think the point we want to stress is that the comparison frequently made is simply between an MLP and a large corporation and a discrepancy there and a suggestion to make this change to remove that discrepancy. But the important thing to keep in mind is if you do that you create a new discrepancy between master limited partnerships and other partnerships and debt financed investments, and you must decide which discrepancy is worse.

The evidence we've brought out in our testimony is that the norm in our country is single taxation. Moving some investment out of that norm to double-taxation worsens neutrality; it does not improve it.

Mr. ANDREWS. Mr. Mentz yesterday discussed tradability as a significant element and a significant problem for MLP's and that troubles me greatly in terms of just fundamental partnership law and putting so much significance on tradability. I wonder if the two of you would care to comment.

Is Treasury putting too much emphasis on that one element?

Mr. CHAPOTON. I think there is no logic in doing so. I make the point in my statement that there is no logic drawing the line on publicly traded—the reason commonly given is that publicly traded corporations have access to public markets, but capital markets are available to a broad range of business ventures.

Similarities exist between large publicly traded partnerships and large corporations, but they also exist on down the scale. There is a lot of difficulty to draw the distinction on publicly traded.

Mr. ANDREWS. Thank you, Mr. Chairman.

Mr. FLIPPO. Mrs. Kennelly?

Mrs. KENNELLY. Thank you, Mr. Chairman. Mr. Chapoton, you were quoted as saying that double taxation can do some terrible things and we shouldn't extend double taxation particularly in this instance unless we are forced to do it. What for some reason would be an acceptable reason that might force us to do it?

Mr. CHAPOTON. I think that if you see a major impact on Federal revenues, I think you have to look at it.

Mrs. KENNELLY. Do you think we have the luxury of waiting, say, a year to look at this area, or are you thinking further out in the future?

Mr. CHAPOTON. I think we can now project, Treasury is now projecting and we have done some independent analysis on projecting the impact on Federal revenues. I don't think our analysis is too different—it is different, but the order of magnitude is not too large when you look at Treasury's numbers. I am puzzled—the Treasury's numbers attached to the tables are not large, as I said in the statement.

But there are references in newspaper reports, which talk about a hemorrhaging of Federal revenues. The hemorrhaging is on this sheet of paper attached to Treasury's testimony. We have since, frankly, had informal discussions since that statement yesterday to see if there is something we are missing and we are told that there is not; that it is all right there. So I think you are entitled to judge whether that is enough of a concern to you, because whether we disagree with the numbers you have to live with the numbers in the budget process, and you have to decide whether those numbers are enough to be of concern to you.

Mrs. KENNELLY. The suggestion is now being made that we tax those limited partnerships that are publicly traded. Are we realistic in thinking that if we tax those all would be solved, or would we continue to see a proliferation of the others? Or do you think these are so new and so attractive for various reasons that they would contract or would they continue to grow?

Mr. CHAPOTON. No, I think that whatever incentives for selecting the partnership route that exist at the publicly traded level exist at every level. If Mr. Mentz is correct, and I suspect he is correct, that there is more incentive after the 1986 act than before for selecting passthrough taxation, we will see it at whatever level it is available.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. FLIPPO. Thank you. Mr. Vander Jagt?

Mr. VANDER JAGT. Thank you, Mr. Chairman, and I thank each panelist for your testimony. I am sorry I didn't have a chance to hear it, but I will look through it.

Mr. Chapoton, you said that there is no likelihood that the MLP's would erode the corporate tax base out into the future because MLP's are used almost exclusively to raise new capital.

Mr. CHAPOTON. That is correct.

Mr. VANDER JAGT. Don't we already have examples of corporations that have reorganized into MLP's for a variety of reasons, tax being only one of them? And if that is true, then what is to prevent more of this in the future and what are the prospects of that happening?

Mr. CHAPOTON. We did see several corporations, and I don't really know the numbers, but certainly we saw in the numbers several corporations liquidate and reform as MLP's prior to the end of the year. It was the last bite at the apple.

The *General Utilities* doctrine was repealed effective January 1 and the tax on capital gain from stock received in liquidation of a corporation was taxed at a lower rate than it will be now. Those changes in the 1986 act will mean that if you attempt to do it this year that you will pay a higher cost to do it.

But some may find it acceptable to pay that higher tax cost because of the tax and nontax benefits. Then it would have to be almost entirely nontax benefits from going the MLP route. The point that Mr. Ballentine could speak to, if you elected to do it and pay the tax, you are accelerating the double tax on income and the acceleration in present value terms means it doesn't matter when it occurs.

The double tax cost is still going to be fully imposed on those assets that are presently in the corporate tax base.

Mr. VANDER JAGT. Does anyone want to add anything to that answer?

One last question—Treasury, I think, proposed that if we do do something that there might be an exclusion for natural resources, and you discussed one of the possible reasons for that being historical. I think the same reasoning might somewhat apply to a real estate exclusion. However, Treasury said that real estate shouldn't be excluded because REIT's now do for the real estate industry what an exclusion would do for the natural resources industry.

Is there any disagreement with that conclusion, that REIT's would serve the purpose just as well?

Mr. CHAPOTON. I would say there would be disagreement in the real estate industry because REIT's are limited to more or less passive activity. Real estate development has normally operated in partnership form. If MLP's are taxed as corporations, I think MLP's operating as real estate ventures will drop back into non-publicly held form, but stay in the partnership form.

Mr. VANDER JAGT. Thank you.

Mr. FLIPPO. Thank you. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. I might mention that a number of us have other competing things going on within the Ways and Means Committee. We have other subcommittees working on other issues, so I have not been able to be present for all the testimony. It is puzzling because if Mr. Mentz is right in his testimony yesterday, then we ought to change the law.

If you are right, Mr. Chapoton, then we shouldn't change the law. It seems to me that if Mr. Mentz contends that this situation with MLP's is going to result in disinvestment of American corporations to MLP form, and that will substantially erode our tax base, then we don't have much choice, but to make some changes.

You come here today and say to us the facts don't support that conclusion and in fact MLP's will not erode the tax base. If you are right, I don't think there is anything that ought to persuade the subcommittee to recommend that we change the law. So we are hampered in trying to determine what are the real facts.

I don't know the answer to that at this point. I think the result of these hearings will give all of us the best information possible with which to judge that. I don't think the fact that an MLP is publicly traded ought to persuade us to do anything with respect to its tax treatment. The fact that it is publicly traded ought not trigger our actions.

I think your statement that it provides some liquidity advantages to investors is certainly accurate. There are some who say because it is publicly traded we ought to change the tax treatment. I don't believe that. But if we have a substantial erosion in revenue because attorneys around America have discovered this new crevice through which they can drag a bunch of clients to dramatically reduce their tax bills, we have trouble.

I read in the paper yesterday that Merrill Lynch has formed a MLP in one of its subsidiaries, apparently some selling subsidiary. Was that formed for new investment purposes? What was the motivating factor that drove the formation of that MLP and what will its tax consequences be for that subsidiary and for the parent company?

Mr. CHAPOTON. The tax consequences will be that the venture will be taxed as a partnership. As I understand the motivating factor, I was not involved in that transaction, but I understand it was a financing technique for a disposition of those assets.

Mr. DORGAN. Was this an existing subsidiary that simply has had its assets rearranged in a different organization or is it something that was designed to attract vast new sources of capital?

Mr. CHAPOTON. It was an existing subsidiary and it was disposed of by Merrill Lynch and the disposition mechanism was through a MLP.

Mr. DORGAN. Will the net result to the Federal Government be positive or negative with respect to the amount of tasks we would expect from those assets?

Mr. CHAPOTON. It is always difficult to do revenue estimating on an individual transaction. Initially the net result will have to be positive, and then you have to see what Merrill Lynch does with the funds because the funds it receives and it pays tax on are within Merrill Lynch's corporate solution—any future assets will be in the MLP.

Mr. DORGAN. If you are analyzing the effect on the Federal Treasury of the future tax liability of that subsidiary? Will this reorganized structure provide an advantage or a disadvantage in terms of the revenues the Federal Treasury can expect as a result of those assets?

Mr. CHAPOTON. I think what you see is the existing asset base, which is in corporate solution, will remain in corporate solution, even though the assets will be in the MLP, what is paid for the assets will remain in corporate solution, and so there is no leakage, no revenue base erosion there. Future appreciation in that corporate base, in that asset, will be outside of corporate solution.

Mr. BALLENTINE. I think the key in looking at the kind of revenue estimate on this particular transaction, as was mentioned in other testimony, in many cases, shares in the partnership are held by the parent corporation so that income remains in its double tax form. Some money comes in from the outside investors investing in the partnership.

The question is what is done with that money? If it is used to pay off debt, it is exchanging one single tax investment for another one. If that money is used to buy new assets that would have been bought by the corporation from new stock issues, then in the long term you get a revenue loss because you have gone from new stock issues that would have been double taxed to new MLP equity issues that weren't.

Our data indicates new stock issues are a very rare form of finance for corporate America.

Mr. DORGAN. Let me ask one more question, Mr. Chairman—

Mr. CHAPOTON. I want to respond to your initial statement about the conflict. Shall I do it now?

Mr. DORGAN. Please.

Mr. CHAPOTON. I think you raised the right point that this committee is facing the dilemma whether the hemorrhaging in corporate revenues is present or not, and whether I am correct or Mr. Mentz's testimony is correct—I don't think I disagree with the facts in Mr. Mentz's testimony.

I think what I am disagreeing with is the conclusion that someone made from those facts, and I think your conclusion from those facts is the important one—if you exclude existing entities in table 3 in the Treasury testimony, and if you look at the revenue picked up over the 5-year budget period and take out of that revenue the effect on passive loss rules, which is shown in the third column, the year-by-year picture is \$50 million, \$42 million, \$74, \$113, \$161, for a total over these 5 years of \$405 million. I don't have any reason to disagree with that even though our studies would show more offset from dividends paid, for example, out by smaller retained earnings. I don't see a hemorrhaging going on there.

Mr. BALLENTINE. Those numbers, that is the total effect. That is not just a pickup coupled with another loss if you do nothing. If you do nothing these numbers show the total budget effect.

Mr. DORGAN. Let me ask once again if you would respond to what I think Mr. Mentz's principal assertion was. He asserted that as a result of the rate changes in tax reform, there is a mechanical advantage in reorganizing as a partnership, as a MLP, and this will persuade many businesses to move in that direction.

That is what he seemed to be saying. You now say there are many other offsetting factors.

He says there is a certain mathematical advantage here, and you say that is offset by other factors?

Mr. CHAPOTON. If you are comparing MLP with equity financing of a corporation, there is a tax advantage to the MLP, but that is not the choice most corporate financial officers have to make. It is between debt or retained earnings versus the MLP.

In addition, if you just look at the incentive before and after tax reform by reason of the tax rates, Mr. Hortenstein's testimony yesterday made the point on the differential. The total corporate tax

after the 1986 act on distributed earnings is 52 cents on a dollar; if you have partnership, 28 cents. That is a difference of 24 cents. Prior to tax reform, it was a difference of 23 cents. There is not a major difference here because of the lower tax rates, though I think when you lower the tax rates, and people can see it, they are going to want to get their hands on the money a little sooner. So I think the incentive is a bit more than the figures would show.

Mr. NEAFSEY. I think you are right that the tax driven characteristics of a MLP are a very small portion of the overall decision as to whether to issue MLP units or not. As is the case in our company and in Transco, each of us had the opportunity during the full year 1986 to issue additional MLP units.

Each have had the opportunity during the year 1987 to issue additional MLP units. The tax incentive is there if that is what is driving you, but neither of us have done it, because there are more fundamental value and economic considerations, shareholder dilution considerations which would preclude one from doing so.

Mr. DORGAN. You are saying, Mr. Chapoton, that the spate of new MLP's at the end of the last year was the last bite of the apple, because of the change in the utilities doctrine, and that that is not in your judgment reflective of the exponential growth of MLP's that we will see in the months or years ahead?

Mr. CHAPOTON. That is correct, although I think there will be growth in MLP's. It is a new method of financing. It has some attractiveness, and I think it will be used.

Mr. DORGAN. This is an issue on which I think a lot of people are open-minded and trying to find out what are the facts. Some of us are shell-shocked from projections made in the past.

I remember the 1981 Tax Act, the projection was that it would shut down tax shelters. Not only did it not shut them down, it created a deluge of tax shelters in America, unprecedented in the history of this country. We are trying to understand where these facts lead us. We appreciate your testimony.

Mr. FLIPPO. Thank you. Thank you very much. We do appreciate very much all of your testimony.

Our next panel today—just for planning purposes I expect that this committee will have to recess at noon, probably about 5 minutes of noon, and for about 35 minutes because of another meeting that has to occur. We are very pleased to have our second panel this morning, Dwayne Whitehead, the executive vice president of the Commonwealth Financial Group; Myles H. Tanenbaum, president of EQK Partners, and John Leyden, vice president of accounting and tax for the International Paper Co.

We appreciate very much you being with us this morning. We would be pleased to receive your testimony at this time. Mr. Whitehead.

STATEMENT OF R. DWAYNE WHITEHEAD, EXECUTIVE VICE PRESIDENT AND TREASURER, COMMONWEALTH MORTGAGE OF AMERICA, L.P., COMMONWEALTH FINANCIAL GROUP

Mr. WHITEHEAD. Thank you, Mr. Chairman and members of the subcommittee. Commonwealth Mortgage of America is a Texas based mortgage company who originates mortgages throughout the

United States through about 70 offices throughout the United States. It then sells those originated mortgages in the secondary market and retains the servicing of those mortgages over the life of the mortgage that is then created.

Commonwealth Mortgage of America is a New York Stock Exchange company. Prior to its formation Commonwealth Mortgage of America was a wholly owned subsidiary of a Houston-based Texas savings and loan. That savings and loan retains approximately 76 percent ownership interest in the master limited partnership which operates as a mortgaging company.

The master limited partnership was initially formed for three primary reasons, to recapitalize the parent savings and loan by recognizing, again, from a sale of a portion of the mortgage company, by selling a portion of that mortgage company and recognizing that gain. We felt that the inherent and previously unrecognized values would be recognized by the shareholders of the savings and loan.

Also in order to grow that mortgage banking company, it had to be outside of the regulatory constraints of the savings and loan. The option of the MLP format was available to us at the time the S&L needed the new capital and resulted in what we believe the most realized value for the mortgage company that the S&L could have recovered at that point in time.

The approximately 17,000 owners of Commonwealth Mortgage of America would be directly affected by any adverse tax position as to the taxation of MLP's as corporations. Those existing shareholders, which are generally small individual shareholders, would be subject to a principal loss relative to the market value of their investment in the MLP and also further, they would be subject to diminished cash flows, diminished returns from that MLP.

The funds received as a result of that transaction by the organization were used by the savings and loan to pay down debt of the S&L, and thus reduce interest expense, which obviously is tax positive for the government. Additionally retained earnings were added to the savings and loan and thus strengthened it relative to the FSLIC guarantees of the deposits for the savings and loan.

Thank you very much.

Mr. FLIPPO. Thank you.

[The statement of Mr. Whitehead follows:]

STATEMENT OF R. DWAYNE WHITEHEAD, EXECUTIVE VICE PRESIDENT AND TREASURER, COMMONWEALTH MORTGAGE OF AMERICA, L.P., COMMONWEALTH FINANCIAL GROUP

Commonwealth Mortgage of America, L.P. was formed in 1986 to realize value in the mortgage operations of the Texas-based savings and loan, Commonwealth Savings.

Commonwealth Mortgage succeeded to substantially all of the mortgage banking business conducted by Commonwealth Savings and its wholly owned subsidiaries. Since, 1977, Commonwealth Savings was actively engaged in the mortgage banking business, which includes the originating, purchasing, selling and servicing of mortgage loans.

Prior to Commonwealth Mortgage's public offering, the shareholders of Commonwealth Savings were unable to benefit from the underlying value the mortgage bank provided. By taking Commonwealth Mortgage public in the MLP format, Commonwealth's management was able to accomplish two significant things. Firstly, Commonwealth Mortgage's public offering recapitalized Commonwealth Savings by having the sale proceeds and a large portion of future distributions flow into the savings and loan. Secondly, management expected that by recapitalizing the savings and loan, the shareholder's market value would be increased by the capital infusion.

One can only speculate as to how Commonwealth, its employees and unitholders would be affected by future tax law changes. Most certainly, our Houston-based employees would be adversely affected. An additional blow that the Houston economy does not currently need.

Most importantly, our unitholders would suffer. Our records show that our unitholdings are spread equally throughout the United States, with concentrations of holdings in New York, California, and Illinois. The loss of cash flow to unitholders would not only negatively impact the local Houston economy, but its effects would be felt by small shareholders, many of whom are your constituents.

**STATEMENT OF MYLES H. TANENBAUM, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, EQK PARTNERS**

Mr. TANENBAUM. I am Myles Tanenbaum, and I am here in my own behalf and as chairman and CEO of EQK Partners, which is the general partner and adviser to EQK Green Acres, a partnership whose shares trade on the NYSE and to EQK Shopping Malls, an MLP that will shortly file a registration statement with the SEC.

My testimony deals with MLP's that own rental real estate and thereby afford liquidity to the investing partners.

We are all here because the Treasury has alerted this subcommittee to a possible loss of tax revenue if businesses traditionally carried as by corporations are converted to MLP's. The Treasury has pointed out that rental real estate investments have traditionally been owned by partnerships and are never owned by corporations except in error.

The Treasury would acknowledge that if real estate MLP's were to be taxed as corporations, no one in this right mind would place real estate in an MLP. Instead it would be owned either by non-trading partnerships or by REIT's. Consequently, there is no threat whatsoever of revenue loss by reason of permitting real estate partnerships to trade—and the Treasury would not challenge that position.

I might say in passing that MLP trading activity could generate tax revenue that would not be received if the partnership did not trade, but that would only be relatively modest revenue.

Now, if there is no revenue to be gained by taxing rental real estate MLP's as corporations, why do so? Why not let real estate MLP's be taxed as partnerships? The answer from Treasury is that since real estate can use REIT's, there is no need for MLP's. That position makes no sense, however.

First, if REIT's did the job, knowledgeable people would use REIT's—rather than MLP's. The market would sort that out. Second, if the REIT rules make sense, why doesn't Treasury advocate adapting them to all real estate partnerships, whether they trade or not—sort of keep the score even. The fact is that the REIT rules do not afford the equivalent attributes provided by the partnership rules as witnessed by the 25-year history of REIT's during which REIT's have failed dismally in bringing investment grade real estate to the average investor.

Forcing real estate to be housed either in a REIT, if it is to trade, or in a partnership that cannot trade does not serve any purpose.

Why not simply face the fact that rental real estate in MLP's do not pose a threat to tax revenue and leave it alone? If other business activities housed in MLP's do present such a threat and Con-

gress wishes to tax such MLP's as corporations, then Congress should do so. But why should the tax laws deny the average investor the opportunity to own a real estate investment when there is no revenue impact involved?

There is no sound reason in tax policy for Congress to be enslaved by some notion of symmetry that has no relationship to economic reality? What is the economic reality? Simply stated, we are in the early stages of securitizing real estate. I should point out that common stock equities in this nation approximates \$3 billion and commercial real estate amounts to somewhat over \$1.5 billion.

While the average investor can buy shares in a full array of blue chip companies, he can buy shares in only a handful of investment grade properties. If MLP's are permitted to survive, I predict, in time, there will be a full array of investment grade properties trading on the exchanges of the nation.

I can tell you from first-hand experience that when any important property in this country is offered for sale, it attracts the full range of potential buyers comprising pension funds, foreign investors, insurance companies and wealthy individuals acting either for their own account or for partnerships. For there to be a viable option to take that real estate public as an effective alternative to selling to the big buyers, the public company must be able to pass along to the investing public the same ownership attributes that would be enjoyed by the private investors.

If the private investors can use the partnership passthrough tax provisions and the public was relegated to the REIT structure, it would be no contest. That game would not be played on that level field we heard so much about last year.

So, if I may summarize, the decision before this subcommittee, as it relates to rental real estate is simple. First, there is no revenue issue. The Treasury would acknowledge rental real estate MLP's do not present a revenue drain. Second, the Treasury would acknowledge that REIT's are inferior structures to partnership, but the Treasury essentially suggests that the REIT should be fixed up.

Third, the Treasury wants to do away with MLP's and use the fixed-up REIT's. That one admittedly is hard to figure out—the MLP's work, the REIT's don't, but Treasury says let's ditch the MLP's and straighten out the REITs. If it ain't broke, why fix it? Why not just let the real estate MLP's provide the investing public the equivalent benefit that private partnerships afford the big investors? And I think it is fair to ask, is it in the cards to expect the REIT rules to be fixed up when Congress just last year amended the REIT provisions and they still don't work.

The REIT concept was a bad idea from the outset; partnerships work and should be recognized as such for rental real estate even when the units trade fully.

[The statement of Mr. Tanenbaum follows:]

Statement of

Myles H. Tanenbaum
Chairman and Chief Executive Officer
EQK Partners

Before The

Subcommittee On Select Revenue Measures

Committee On Ways And Means

U.S. House of Representatives

July 1, 1987

Mr. Chairman and Members of the Subcommittee:

My name is Myles H. Tanenbaum and my testimony is submitted in behalf of EQK Partners, and two limited partnerships sponsored by EQK Partners for which it acts as adviser: EQK Green Acres, L.P., which owns a super-regional shopping mall whose units are listed on the New York Stock Exchange, and EQK Shopping Malls, L.P. which has contracted to acquire four regional shopping malls and will soon file a Registration Statement with the S.E.C.

EQK Partners is a joint venture between The Equitable Life Assurance Society of the United States, and my partners and I who own Kravco Company (the nation's fifth largest developer and manager of shopping malls). EQK Partners has pioneered the securitization of real estate equities, having been formed in 1983. Its first effort was a real estate investment trust (EQK Realty Investors I) which introduced the concept of a fully-specified, closed-end, finite life equity real estate investment product.

My testimony deals with investment grade rental real estate owned by limited partnerships whose shares are freely tradeable, thereby affording liquidity to the partners.

The premise which underlies this testimony is that liquidity, as an incident to real estate investment, affords a significant socio-economic advantage. Liquidity enables ownership interests in real estate to be transferred in a manner similar to publicly traded stocks and bonds.

Such liquidity means (a) the price "assigned" to a real estate partnership interest would be the product of the market forces of supply and demand, under the "microscope" of the full disclosure required by the securities laws; (b) partnership share offerings burdened by uneconomic charges will be foreclosed by reason of broad market disclosures and the competitive forces of daily trading; (c) capital committed to real estate investments can be readily converted to alternative uses or investment and is not locked out of such other opportunities; and (d) the opportunity to participate in real estate investment will be afforded to the full range of investors, including the "small investor," by reason of the lower threshold minimum investment.

Summary of Comments and Recommendations:

- Imposing corporate tax treatment on MLPs owning rental real estate will produce no increase in tax revenue because such legislation would simply put an end to MLP ownership of such real estate: given the choice between liquidity with the added cost of

corporate taxation and single-tiered taxation, via illiquid partnerships or individual ownership, the time-honored non-tradeable format will always be selected.

- Holding rental real estate in publicly traded limited partnerships ("MLPs") will generate more tax revenue than would be the case if the real estate were owned either by limited partnerships that do not trade or by traditional real estate investors, namely pension funds, foreign investors, insurance companies and wealthy individuals.
- Without MLPs, the "small investor" would once again be foreclosed from "investment grade" real estate opportunities and be relegated to such rental real estate investments as would be available via non-tradeable limited partnerships. In addition, such investments would be burdened by the higher fees and other charges associated with non-trading offerings, erasing the progress recently made in reducing such costs by reason of the competition afforded by the publicly traded limited partnerships which are judged daily in the harsh truth of the securities market auctions.
- Real estate investment trusts ("REITs") do not meet the competitive challenge of the partnership structure and they also suffer from certain legislative burdens, discussed below, which make REITs less desirable structures from the standpoint of the sponsor and the investor.
- Our testimony in favor of continuing partnership tax treatment for publicly traded rental real estate investments should not be construed as advocating that other MLPs should be subject to two-tier taxation. Rather, our remarks are intended only to demonstrate the reasons rental real estate MLPs should continue to be afforded partnership status notwithstanding that they are publicly traded.

A. Rental Real Estate Investments -- Background and Relevance.

1. Size of the Market. Estimates concerning the aggregate dollar amount of commercial rental real estate range upward of \$1.5 trillion, net of related mortgage indebtedness. That amount compares surprisingly well with the value of all common stock equities, estimated to be \$3 trillion. Whereas common stock equities trade freely, virtually all rental real estate has been closely held and does not afford investors the liquidity associated with securities.

2. What it Takes to Own Investment Grade Rental Real Estate. Virtually all of the investment grade rental real estate in the United States is owned by the people who developed or currently use the properties, or by pension funds, insurance companies, foreign investors and wealthy individuals. A small portion of such real estate is held by real estate investment trusts ("REITs") and non-tradeable "public" limited partnerships -- but, for the most part, the quality of the properties held by the REITs and public partnerships is below what knowledgeable investors classify as "investment grade." Consequently, until recently, so-called small investors have not had the opportunity to access investment grade real estate. By contrast, such investors have had, and will continue to have, the opportunity to invest in the common stock of virtually every blue chip company in the nation -- and that is because such stocks trade daily on the capital markets. "Securitization," in time, will afford a similar opportunity with regard to equity real estate, provided tax legislation does not inhibit such real estate investments from being offered in "pass-through"

entities (i.e., does not deny the tax and investment attributes otherwise available to major investors).

B. Rental Real Estate Investments Have Traditionally Avoided a Two-Tier Level of Taxation.

1. **Individual, Partnership and Tax-Exempt Ownerships.** As noted above, the ownership of rental real estate has traditionally been in a format which precludes an entity level tax, and increased real estate investment by pension funds over the past two decades has eliminated taxation for properties acquired by such parties. Tax advisers have studiously steered their clients from corporate ownership because it would create an added level of taxation. To be sure, corporate ownership always represented a simple and convenient mode, but it entailed an added tax cost which found no economic justification. Investors having the opportunity to participate in real estate investment via a "pass-through" (partnership) tax structure will be the "marginal" buyers who effectively set the competitive price/yield for the acquisition of properties. "Pass-through" without an MLP will always be available to major investors. The small investor could invest with a "pass-through" structure only via REITs and non-tradeable limited partnerships, both of which have serious investment limitations for reasons discussed in subsequent sections of this statement.

2. **Real Estate Investment Trusts ("REITs").** During the past quarter of a century that real estate investment trusts have been authorized by Congress, the liquidity option was afforded to real estate investors without the "price" of a second tier of taxation or an MLP structure. REITs, however, have occupied only a minor position in regard to real estate investment, perhaps because REITs do not feature portfolios with "investment grade" properties. The REIT legislative rules are so restrictive as to render REITs less competitive in acquiring quality real estate, thereby making REITs a far less desirable form of ownership than limited partnerships, whether non-trading or MLPs. Among the more significant concerns relating to REITs are the following:

(a) Regrettably, it seems inevitable that legislatively created entities have intricate, multiple tests or requirements. In the case of a REIT, there is the organizational test, the income test, the asset test and the distributional requirement. Each of these present problems that constrain entrepreneurs. It is not simply the fact of regulation. Rather it is the complexity and its concomitant, namely, the opportunity to trip on a technical non-compliance, which makes one more than a little bit cautious. Our organization did bring to market a REIT (EQK Realty Investors I) and in the course of doing so and by reason of the aftermath of its operation, we learned by first-hand experience the discomfort of these hurdles. We must avoid "bad" income; we must observe "safe harbor" rules regarding sales; we must render certain services through "independent" contractors; we do not provide our investors the equivalent tax features available to partnership investors; and, sadly, there are even more technical pitfalls.

(b) But, from the standpoint of the sponsor of a REIT, perhaps the most serious obstacle is one which might otherwise seem innocuous. I refer to the requirement that the five largest shareholders may not own 50% or more of the outstanding shares at any time during the last half of the year. Why is this so serious? The answer, quite simply, is that providing the opportunity to acquire "investment grade" real estate at its fair market price inevitably will attract the acquisitive desires of those who have been the dominating parties in the acquisition of investment grade real estate. Those parties are driven by self-interest to ferret out whatever prime properties are available for acquisition and to make every effort to purchase them. Consequently, a real estate investment trust owning desirable ("investment grade") real estate will sooner or later become a "take-over" target. In the case of a REIT, a move on the shares could result in elimination of the REIT status, leading inevitably to liquidation. A sponsor would not want to undertake the enormous burden of bringing a REIT to market with

"investment grade" properties only to witness the demise of the REIT via acquisition of "too large" a share by a "competitor."

C. Competition -- The Ultimate and Inevitable Test.

1. Competition in the Acquisition of Real Estate. "Investment grade" rental real estate is purchased for the purpose of obtaining the investment yield that can be produced by the property. Unlike a position in corporate management, there is no power or prestige attributable to ownership of real estate except to the extent that the investment itself provides a satisfactory or even better investment result. Consequently, real estate acquisition, for the most part, is a "numbers game" undertaken to achieve the ultimate objective of a minimally acceptable yield. In that light, it should be obvious that differentials among potential buyers with regard to benefits and burdens will make one party more competitive than the others -- such differentials involving taxes, administrative costs, operational freedom, financing, etc. generally will inure to the benefit of the party having greater flexibility, less regulation and a more favorable tax structure. Generally, that equates with a partnership format. That, in turn, means an entity regarded for tax purposes as a corporation cannot be competitive when it comes to acquiring the properties sought by the major investors, specifically investment grade real estate.

2. Competition Via Liquidity -- Is it Worth the Price? Without question, liquidity has a price. It is not inexpensive to undertake a public offering and to meet the related somewhat burdensome reporting requirements. If the value added by liquidity is equal to or greater than the related cost, a publicly traded entity certainly would offer a competitive investment product. But the "measurable" advantage of liquidity is not such that it can also sustain the added more significant "cost" of a double level of taxation.

3. Liquidity at the Price of Corporate Taxation. Liquidity for real estate investment is a product of the joint conviction of an entrepreneur and a securities firm that "the market" will accept a proposed price/yield structure for a real estate product. Is it realistic to presume that an entrepreneur would make the substantial investment needed to bring such a product to market if it would be offered at a price/yield competitive disadvantage to non-tradeable real estate investment? If such an entrepreneur surfaced, is it at all likely that a securities firm would agree to undertake such an offering? The answer to both questions, without equivocation, is "NO." The overwhelming likelihood is that either the entrepreneur, the underwriter or both will be deterred by the recognition that the knowledgeable investor would not be likely to choose liquidity at the price of a significantly reduced investment yield attributable to double taxation.

D. Tax Revenues -- The Impact of Double Taxation.

1. MLPs Subject to Corporate Tax Treatment. For reasons expressed above, imposing corporate tax treatment on MLPs owning rental real estate will simply put an end to MLP ownership of such real estate. Consequently, a corporate tax imposed on MLPs will equate with no added tax revenue.

2. MLPs Recognized as Partnerships. By their very design, MLPs provide the equivalence of the underlying real estate trading freely. With liquidity, the frequency and dollar volume of turnover of such real estate is increased dramatically in contrast with the turnover of non-trading limited partnership interests. Such trading, in turn, produces a concomitant increase in taxable transactions which could lead to added tax revenues. For example, during the first year following its listing on the New York Stock Exchange, trading activity in the shares of EQK Green Acres, L.P., for which EQK Partners serves as adviser, will aggregate a bit over 30% of its total shares. In contrast, there had been no sales at all during the preceding 9 1/2 years when Green Acres Mall was owned by the predecessor non-trading partnership. Such an increase in real estate transactions will create tax recognition solely by reason of the liquidity provided by MLPs.

E. Public Policy -- Liquidity is The Touchstone to Investment Opportunity.

1. Who Needs Liquidity? Real estate investments have traditionally been closely-held, whether by outright ownership or via joint ventures with limited participants. Offered the prospect of a broadened market with liquidity, many of those who have been successful in this format may well subscribe to the notion that "if it ain't broke, why fix it." And why not? Participants in a marketplace with relatively few players would certainly not be anxious to see increased competition for obvious reasons. But a market restricted to a limited number of large players is not healthy in a democratic society. Denying public trading equates with reduced participation by the "small investor" and no sound argument can be made in support of such a position. It would seem particularly indefensible for reduced small investor participation to be attributable to tax legislation which has no prospect of generating revenue.

2. Non-trading Limited Partnerships -- The Alternative to MLPs. Were there to be corporate taxation of MLPs, thereby leaving non-trading limited partnerships as the logical alternative, should this be a cause for concern? We think so. Because the pricing and economic validity of investments in non-trading limited partnerships are not tested against the daily auction in the securities marketplace, there is no market mechanism to control the avarice of the promoter/distributor in the selection of real estate or the imposition of charges. Indeed, the quality of the real estate which has been included in such limited partnerships, and the fees and other charges related to such offerings, have been questionable, at best. It is noteworthy that fees associated with such offerings have dropped sharply only during the past few years when the fees related to securitized real estate offerings -- which are tested by their impact on yields and daily market quotations -- have provided a stark counter-point to those which burden the illiquid limited partnerships, the investment alternative for the small investor. In that light, the issue once again must be phrased in terms of questioning the justification for enactment of a non-revenue generating tax law that inhibits broad market participation in "investment grade" rental real estate and permits illiquid offerings to dodge the market test of reasonableness.

F. Rule Changes -- The Task of Drawing Lines and Creating Transitional Relief.

1. The Search For Tax Revenues -- Distinctions Should be Drawn. While there is an obvious concern that loopholes in the tax laws could create a loss of needed tax revenue, common sense and sound judgment should govern every attempt at loophole plugging. To tax MLPs which own rental real estate as corporations will not plug any loopholes and may very well lead to a loss of tax revenue for the reasons noted. Congress is accustomed to drawing fine lines, and does so frequently when drafting tax legislation. If there is a perceived need to prevent a potential loss of tax revenue by taxing MLPs as corporations, for the reasons outlined, MLPs owning rental real estate should be excepted and permitted to retain partnership status.

2. Transitional Rules -- The Essence of Sound Governance. Publicly traded limited partnerships are clearly taxable as partnerships under existing law. If the law were to change, it is hard to conceive that Congress would make such a change applicable to MLPs now in operation or in an advanced stage of formation. With respect to the former, such legislation would overnight remove 34% of the net income and presumably a similar share of the market price of such securities. Such a "removal" would occur right before the very eyes of your taxpayer constituents who presumably had exercised sound judgment in making their investment commitments. To remove 34% of an individual's savings should be supported by a compelling need. That is not the case in this instance. It certainly would raise serious doubts within the investment community in that

legislation of this sort could be -- more appropriately, should be -- made prospective only. A "retroactive" application would be essentially confiscatory and consequently would spawn serious doubts and concerns with regard to the mindset of a Congress unwilling to stand behind clearly implied promises of essential fairness in all legislation.

3. Commercial Activities Are Always Based on Existing Law -- Retroactivity is Anathema. An undertaking to assemble real estate for a public offering via a limited partnership is a rather long, arduous and expensive effort. With regard to the proposed offering of EQK Shopping Malls, L.P., sponsored by our company, the costs to date have reached the \$1 million level and the filing is still a few weeks away. Should any legislation be proposed with regard to taxing MLPs as corporations -- irrespective of whether such legislation is ultimately adopted -- the impact would be an immediate death knell to the offering. Because the period during which the real estate in question is under contract (September 30, 1987) will terminate before the legislative issue is resolved, our concern relates to the introduction of such legislation following these hearings. Unfortunately, the possibility of such legislation has already created a cloud on the offering. Hopefully that cloud can be removed by a prompt and forthright statement to the effect that any rule change would be prospective only, accompanied by a set of transitional rules that would safeguard those undertakings already in the pipeline.

Conclusion:

An important theme embodied in last year's Tax Reform Act was the need and desirability to "neutralize" the impact of tax legislation on business and investment activity. We so frequently heard expressed the virtue of enabling all taxpayers to play "on a level field." The issue facing this Subcommittee, insofar as it applies to opportunities for the small investor to acquire "investment grade" real estate, essentially is a challenge to the willingness of Congress to hold to that principle.

Tax legislation which places a second-tier of tax on those MLPs which afford rental real estate investment to investors will foreclose such an opportunity; no tax revenue will be gained by such an enactment and it is likely corporate taxation will actually reduce tax revenue; and the "small investor" will be relegated to the non-trading limited partnership offerings with their traditionally higher fees and their penalizing resale price when an investor wants to cash out prior to complete liquidation.

How can such a result be justified? It cannot! MLPs that own rental real estate should continue to be regarded as partnerships for Federal income tax purposes.

MHT/dmb
July 1, 1987

Mr. FLIPPO. Mr. Leyden.

STATEMENT OF JOHN T. LEYDEN, VICE PRESIDENT OF ACCOUNTING AND TAX, INTERNATIONAL PAPER CO., ACCOMPANIED BY MARK CAPONE, DIRECTOR OF PARTNERSHIP TAX ADMINISTRATION

Mr. LEYDEN. Thank you, Mr. Chairman.

My name is John Leyden, and I am vice president of accounting and tax for the International Paper Co. I am here today representing both International Paper Co., which is the world's largest paper company, as well as its 90-percent-owned publicly traded limited partnership, IP Timberlands, which owns over 7 million acres of timber lands.

With me, on my right, is Mark Capone, chief tax officer of IP Timberlands.

I would like to thank the subcommittee for the opportunity to address what we believe are some misconceptions and myths regarding publicly traded partnerships. Just as corporations are often mistakenly perceived as paying little or no tax, we at International Paper Co. are concerned that the human tendency to believe the worst will fall prey to idle statements and narrowly drawn conclusions regarding the use of publicly traded partnerships to avoid corporate tax. We do not believe that corporations will disincorporate or International Paper would have put all of its assets into a partnership rather than just its timber lands which represented less than 15 percent of its asset base.

At the outset, I would like to state that IP Timberlands was formed by International Paper for nontax reasons. We believe that the partnership form represents the most efficient and appropriate for of managing our timber resource base, to accomplish both immediate as well as long-term business objectives.

During the period 1980 to 1985, just prior to the formation of IP Timberlands in March 1985, the forest products industry in this country was in a depression. Low earnings, and stock prices below book value of assets, put pressure on companies such as ours not only to improve earnings but also to raise capital.

Management had long been aware that little or no value for our timber land base was reflected in the price of our stock. This, we believe, was due to a lack of understanding by the investing public of the economic of timber land ownership.

For the most part, timber land ownership outside of the corporate sector had been limited to investors with large sums to invest for long periods of time in a somewhat risky business.

In addition, private timber land ownership, which accounts for 72 percent of the commercial timber land in this country, was on the decline.

The formation of IP Timberlands permitted International Paper Co. to accomplish the following objectives:

First, we established a value for our timber lands. Our historical book value was approximately \$800 million. But the market value established by investors in our partnership, as supported by independent appraisals, was in excess of \$3 billion, almost a fourfold increase.

In management's view, this increased value ultimately was reflected in our stock price, thereby facilitating equity financing on the order of \$170 million in the fall of 1986.

Second, International Paper was able to monetize an asset. By issuing units to the investing public, we raised \$50 million of new investment in timber lands and, by a subsequent sale of IP-owned units, we raised \$100 million of new capital, while at the same time improving earnings.

And third, investors of modest means were able to invest in timber lands in a liquid and relatively risk-free environment. In addition, the creation of IP Timberlands will permit existing timber land owners to reduce their risks and convert an illiquid investment into a liquid one, by contributing their timber lands to the partnership.

Regarding tax consequences, we believe that in forming IP Timberlands, there is no erosion of the corporate tax base.

First, all of the inherent gain in the properties contributed to the partnership, measured at the date of formation, will ultimately be taxed to International Paper Co.

Second, most investors in IP Timberlands are taxpaying individuals. On the other hand, 60 percent of International Paper Co.'s stockholders are tax-exempt pension funds or institutions that do not pay tax on corporate dividends. Therefore, it is hard to see how taxes are being avoided.

And third, International Paper's dividend level has not been reduced since the formation of IP Timberlands; therefore, the earnings and cash flow distributed by IP Timberlands has not decreased the tax liability of International Paper Co. or our stockholders.

As a matter of fact, the creation of IP Timberlands produced a tax windfall to the Federal Treasury. IP's sale of \$100 million of partnership units in IP Timberlands accelerated \$62 million of taxable gains that otherwise would not have been recognized.

Furthermore, the use of equity, rather than debt financing, converted what otherwise might have been tax deductible interest expense into nondeductible dividends.

In concluding, I would like to state that IP Timberlands was formed for legitimate, nontax motivated, business reasons. We believe that IP Timberlands is good for our company, good for our stockholders, good for investors in IP Timberlands and good for our Nation's economy.

We appreciate the opportunity to present our views. Thank you.
[The statement of Mr. Leyden follows:]

John T. Leyden
Vice President, Accounting and Tax
International Paper Company
Two Manhattanville Road
Purchase, New York 10577

HISTORICAL COMMENTS

International Paper Company ("IP") is the world's largest paper company and through its majority owned publicly-traded partnership, IP Timberlands, Ltd., (hereinafter referred to as IPT) IP controls over 7 million acres of timberland, which we believe is the largest single concentration of timberland ownership next to that held by the federal government.

IP is principally engaged in the manufacture and sale of products in four forest products industry segments -- namely, pulp and paper, paperboard and packaging, wholesale building materials distribution; and wood products and resources. In addition, IP manufactures non-woven textile products and, through subsidiaries, is engaged in the development of real estate and mineral properties, the operation of a contract oil and gas drilling business and agriculture.

During the period from 1980 through 1985, while most of the country was in a recession, the forest products industry was in a depression. Substantially reduced earnings levels and low stock prices relative to book value combined to present management with a serious dilemma, that is, how to increase earnings and/or the company's stock value to a level that could support either the debt or equity financing necessary to raise capital.

In an effort to improve the company's stock value, management concentrated on ways to enhance asset values. Management believed that our timberland resource base represented an asset that was given little or no recognition by investors. This was the case principally because the economics of timberland ownership were so closely entwined with IP's manufacturing operations that investors did not have the opportunity to understand the economics of timberland ownership as a separate business. Traditionally, non-corporate timberland ownership has been limited to wealthy investors with substantial sums available to invest over long periods of time and those who wish to make long term investments in purchasing and managing land.

IP's management, therefore, set out to find a vehicle that would:

- Increase the market value of company stock to a level commensurate with the economic value of its timberland asset base.
- Provide for a liquid form of investment that would attract all investors and not just the wealthy.
- Permit monetization of an asset as a means of raising capital.
- Permit continued control of a vital resource base.
- Demonstrate the economics of timberland ownership to the investing public.

After a complete review, IP's management determined that a limited partnership was the best means to realize the above objectives.

Prior to March of 1985, IP's timber resource base consisted of direct ownership or control of approximately 7 million acres of timberland in the United States. In March of 1985, IP formed IPT, a Texas limited partnership, to succeed to substantially all of IP's timberland resource base. IPT features two distinct classes of ownership interest, Class A and Class B depositary units. The Class A and Class B units differ in several respects, the most important being their participation in partnership cash flow and earnings. The Class A depositary units, which trade on the New York Stock Exchange, share in 95% of the cash flow and earnings from timber harvest during the first 15 years of the partnership (1985-1999). Thereafter, the units share in only 4% of timber harvest revenues. The Class B depositary units, which are owned entirely by IP, share in 4% of the cash flow and earnings for the first 15 years and 95% thereafter. The remaining 1% of cash flow and earnings goes to the general partners. After the initial public offering in March of 1985 which resulted in 5% of the Class A units being held by investors, a secondary offer ensued in October of 1985 wherein an additional 11% of the Class A units were sold by IP leaving IP with its present ownership of 84% of the Class A units and 100% of the Class B units.

REASONS FOR THE CREATION OF IP TIMBERLANDS, LTD.

IPT afforded management the opportunity to enhance the value of IP stock by highlighting the value of its timberland asset base through the partial sale of partnership interests to the public. In addition, it provided IP with the means to raise essential capital in an efficient and nondilutive manner without relinquishing control of its vital resource base, while at the same time creating a new versatile security that could be used for prospective acquisitions of timberlands. Furthermore, IPT resulted in the creation of a new capital market in which investors of modest means for the first time had the opportunity to invest in timber ownership with substantially fewer risks and greater liquidity than ever before possible.

RECOGNITION OF THE VALUE OF TIMBERLANDS IN IP STOCK - During 1983 and 1984, the historical book value of IP's timberlands was approximately \$800 million or 13.5% of total book value of the company. These same assets were valued at \$3 billion both by independent appraisals and subsequently by the marketplace in connection with the formation of IPT. Notwithstanding the enormous appreciation in the value of IP's timberlands, IP stock traded well below its book value in 1983 and 1984. Thus, recognition was not given to the timberlands value principally because the timberlands operations were so entwined with other IP manufacturing

of timberland ownership. IP's management believed that recognition of the value of its timberland asset base could be achieved by the monetization of such base, through the creation of IPT and sale of partnership units to the public. Since the inception of the partnership, IP's stock has been trading at nearly one and a half times book value, much of which management believes can be attributed to the creation of IPT as well as improved economic conditions within the industry. Moreover, IPT's contribution to the overall improvement in the company's stock price lent additional leverage and support to IP for further equity and debt financing required for the company's capital expenditure program of approximately \$500 million annually.

NEW VERSATILE SECURITY - With the ever increasing demand for wood and paper products, units of IPT afforded IP management the opportunity to increase its timberland base and meet the increased demands without raising additional debt or equity capital. Unfortunately, such acquisitions have not materialized in light of the uncertainties surrounding the future of publicly-traded limited partnerships.

ACCESS TO CAPITAL OF MODERATE INVESTORS - IPT provided IP with the opportunity to raise essential capital (approximately \$150 million to date) from a new source ---the middle income investor---. This was made possible because of the accessible selling price of the partnership units (around \$25 per unit) and the increased liquidity of the investment. Formerly, investment in timber property was reserved for only the wealthy investors and those who wished to make long term investments in purchasing and managing land.

In summary, the business and economic reasons outlined above were the principle criteria for the formation of IPT. While taxes are always a consideration in the selection of a business entity, the selection of partnership form did little to change tax consequences since substantially all of IPT's income is still being taxed at the corporate level.

REBUTTAL TO CONCERNS RAISED AGAINST PUBLICLY-TRADED LIMITED PARTNERSHIPS ("PTP'S")

Over the course of the last several years concerns have been raised about PTP's and attempts have been made to alter their tax status. However, as we hope to demonstrate in this testimony, these concerns as they relate to IP Timberlands, Ltd. and many other PTP's in existence today, do not provide sufficient support to alter or change the tax treatment of these entities.

The more significant concerns raised by critics are: (1) PTP's are so similar to corporations that they should be taxed as corporations; (2) avoidance of the corporate tax by PTP's will lead to the disincorporation of American companies; (3) disincorporation will cause substantial loss of tax revenue and; (4) the complexity of PTP's cause substantial compliance problems.

(1) SIMILARITY TO CORPORATIONS

From inception, our nation's income tax provided two tax regimens, (1) a two-tier tax levied on corporations, and (2) a single-tier tax levied on partnerships and other pass-through entities. The corporate income tax originated as a tax on state law corporate privileges. Accordingly, it was only logical that classification between corporate and non-corporate status, which dictates which income tax applies, be based on the presence of state law corporate privileges. During the development of the corporate income tax, Treasury responded to this logic by

creating, through regulations, a corporate resemblance test which includes the most recognized corporate privileges. These regulations, which have remained basically unchanged since 1960, provide that (i) an organization having associates and (ii) an objective toward carrying on a trade or business and dividing profits therefrom, will be taxed as a corporation if such organization possesses at least three of the following characteristics: (1) continuity of life, (2) centralization of management, (3) liability of corporate debts limited to corporate property, and (4) free transferability of interests.

Clearly, the corporate privilege of transferability of interests is present in all PTP's. Conversely, the corporate privileges of continuity of life and limited liability are not present. In addition, many times centralization of management is not present. Thus, as indicated by example in Treasury regulations, a limited partnership which has free transferability of interests and may have centralization of management but lacks continuity of life and limited liability, will not be classified as a corporation. The partnership agreement of IP Timberlands, Ltd. requires the partnership to dissolve upon certain events leading to the retirement or withdrawal of the general partner. Thus, by its very structure, IPT's life is limited. Furthermore, to insure that at least one general partner had substantial assets, IP lent its new worth as a general partner, thereby exposing its entire asset base to the claim of creditors. Accordingly, under well established tax law and regulations, IP Timberlands, Ltd. is not and should not be classified as a corporation for tax purposes.

Notwithstanding that IPT and most other PTP's are correctly classified as non-corporate entities, some critics believe that the free transferability of interest characteristic should be the corporate privilege which most justifies the imposition of corporate tax. However, to elevate this privilege to the most important characteristic in determining corporate status would be absurd. Otherwise, existing corporations in this country, of which 98% are not publicly traded, would fall prone to reclassification for income tax purposes. Moreover, consider the fact that there are many large publicly-registered but unlisted partnerships with thousands of partners. These partnerships are as large as PTP's and conduct similar type businesses. According to a tax report submitted to the Senate Finance Committee in 1983 there were, as of 1980, 676 partnerships with more than 1,000 partners each, grossing nearly \$6 billion with net earnings of nearly \$1.5 billion. To distinguish these delisted partnerships from PTP's because the latter trades more freely in an orderly and established market would be discriminatory and unfair tax policy. In fact, non-traded partnership interests could theoretically trade freely outside the conventional marketplace. Moreover, publicly registered partnerships that raise capital through private investment are required by federal and state securities laws to sell interests to accredited investors. Generally, to be accredited, an investor must have net worth in excess of \$1 million or income in excess of \$200,000. Accordingly, a rule that would require reclassification because of tradeability would discriminate against the middle income investors in favor of the wealthy investors.

In summary, there are many substantial distinctions between PTP's and corporations, and, as long as such

distinctions exist, the tax applicable to PTP's and corporations should be respected.

(2) DISINCORPORATION

Outspoken critics have claimed that the advent of PTP's will lead to the disincorporation of American companies. This concern most likely originated from the Economic Recovery Act of 1981 which reduced the maximum tax on individuals from 70% to 50%. The reduction substantially reduced the spread between corporate and individual rates and thereby seemingly lessened the benefits of incorporation. This claim was further amplified through the passage of the Tax Reform Act of 1986 which reduced the individual rate below the corporate rate.

Notwithstanding the change in the rate differential, a mass exodus to the partnership format is highly unlikely and illusory at best. First and foremost, mass disincorporation to the PTP format presupposes that any type of business activity could effectively operate within the partnership format. If that were the case, IP, after closely reviewing the partnership form of doing business, would have elected to disincorporate its entire business operations.

As mentioned earlier in this testimony, units of a PTP are perceived in the marketplace as yield driven investments. Thus, their marketability is based upon an anticipated cash return to investors. The average cash return on PTP's units selling in the marketplace today is between 10 to 11%. Since many public corporations have capital intensive businesses, it is extremely difficult to conceive that most of these corporations could disincorporate to PTP format and establish a cash distribution policy to meet the required yields of the PTP's marketplace while simultaneously retaining sufficient cash for reinvestment needs. Moreover, the foremost disadvantage has to be the inaccessibility to the institutional investor. Pension funds and other tax-exempt entities have become the most predominant players in the capital market today. However, the presence of unrelated business taxable income (UBTI) effectively prohibits these entities from investing in PTP's.

In summary, the PTP formation is limited to unique business assets such as IPT's timberlands which generate a very predictable cash flow and can operate without need of institutional capital and major reinvestment requirements.

(3) REVENUE LOSS

One of the most severe criticisms of PTP's is fear of the erosion of the corporate tax base. This concern assumes that a substantial number of incorporated business will disincorporate and that a substantial number of future business activities will not choose the corporate form.

For reasons just mentioned above, it is highly unlikely that a substantial number of corporations will disincorporate or that future businesses will take the form of the PTP. Moreover, to the extent that businesses have taken the PTP form there would appear to be, if anything, a revenue gain. This conclusion can be reached by examining how PTP's are formed.

Approximately one-third of the PTP's to date were formed through the method commonly referred to as the "roll-up". Under this method a PTP is formed by

rolling up previously existing non-traded partnerships into a traded partnership. Nearly one-half of existing PTP's were formed by way of a "roll-out". Under this method sponsor corporations contributed assets to a PTP in exchange for units. The remainder of the existing PTP's were formed by various methods including an offshoot of the "roll-out" method called the "acquisition method" or "acquisition PTP". Under this method a PTP is formed and a taxable acquisition is made of the sponsor corporation's assets following a public offering of units.

PTP's formed under the roll-up method can be viewed as revenue neutral at best since the prior non-traded partnerships were not subject to the corporate tax. If anything, the formation of these PTP's created a revenue gain due to the triggering of recapture income and the loss of percentage depletion.

PTP's formed under the acquisition method cause the corporate sponsor to be fully taxed on the gain realized from the sale of assets. Accordingly, formation of PTP's under this method should not be viewed as an erosion of the corporate tax base, but, in fact, as an acceleration of the corporate tax that would have been realized on the future income stream from the properties that were sold.

PTP's formed under the roll-out method generally cause no immediate taxation to the sponsor corporation. However, the tax basis in the property contributed is substituted in the basis of the partnership units received by the sponsor corporation which, if sold in a secondary offering, will immediately trigger the inherent gain in the assets at the corporate rate. This result is not any different from a corporation selling its assets outright. Once again, an acceleration of future corporate tax will occur. Furthermore, as the PTP sells partnership property received from the sponsor corporation, the inherent gain in this property is allocated to the sponsor corporation under partnership tax law.

IP Timberlands, Ltd. was formed under the roll-out method. IP contributed substantially all of its timberland asset base to IPT in exchange for Class A and Class B units. Under partnership tax rules any inherent gain in the property contributed is allocated back to the contributing partner when the partnership sells such property. In 1985 and 1986 IPT had distributable taxable income of \$59 and \$80 million, respectively. Because of this tax rule and IP's significant holdings in IPT, 95% of the distributable taxable income for 1985 and 93% for 1986 was allocated to the company. Accordingly, substantially all of the taxable income of IPT is being taxed at the corporate level. Moreover, IP sold some of its Class A units in a secondary offering. This sale caused the immediate recognition of \$62 million of gain representing part of the inherent gain in the timberland assets contributed to IPT.

Finally, the perceived notion that tax revenue is lost because of the spread between shareholder taxation and individual taxation is misleading and unfounded. Critics have preached that the spread between the maximum tax applicable to corporate profits of 52% (34% corporate tax and 28% shareholder tax on dividends, as planned under the TRA of 86) and the maximum rate to individuals of 28% causes a substantial loss to tax revenue. However, it must be recognized that the actual spread is significantly less because few, if any, corporations pay taxes at the maximum rate

(albeit, subject to the alternative minimum tax) or annually distribute their entire net earnings. Corporations generally pay dividends far less than their net earnings because of reinvestment needs and debt requirements. The simplest way of avoiding taxation of corporate profits is the use of debt capital as a substitution of equity capital. With the increasing use of debt, witness the emergence of "leveraged buyouts" and "junk bonds", corporate borrowers are able to substantially reduce corporate profits through interest deductions. Attendant to this borrowing is the need for indefinite retention of corporate profits to service the debt and, thus, the minimization of dividends. On the other side of this equation are the shareholders and the lenders, principally tax exempt entities such as pension trusts and other institutions which pay little or no tax. Approximately 60% of the outstanding shares of IP are held by institutional investors such as these. This fact pattern is not at all different from most other publicly-traded corporations. Thus, a substantial portion of the dividends that are paid are being subject to little or no tax at all. The same argument, but to a greater extent, can be made for receivers of interest since the institutional investors are the largest lenders in the debt capital market. For these reasons and others, the total tax realized on corporate profits is far from the maximum of 52%.

Contrast this situation to the PTP environment. Most PTP's in existence today, including ours, carry little or no debt. As stated above, the cash distribution requirements of PTP's preclude the carrying of significant debt. Conversely, most capital raised in the PTP market has been used to replace debt of the corporate sponsor thereby increasing taxable earnings through the reduction of interest expense and thus increasing the corporate tax. Additionally, 100% of the PTP's taxable income is deemed distributed annually to taxpaying individuals or corporations.

Based on the aforementioned analysis, it is extremely difficult to claim that PTP's such as ours may or will cause a loss of tax revenue. On the contrary, it seems more realistic that IP Timberlands, Ltd. as well as other PTP's have and will cause a revenue gain.

(4) COMPLIANCE

Critics have feared that because of the size and complexity of PTP's and the constant transfer of partnership units, tax compliance cannot be achieved. Although compliance for PTP's is complex, it is not materially different from the problems associated with small partnerships or large non-publicly traded partnerships.

Moreover, substantial sums of money have been spent to develop sophisticated software programs to administer compliance. These systems provide specific tax information to unitholders about their unit ownership so that their distributive share of partnership taxable income can be determined. Additionally, the new nominee reporting rules will greatly assist and enhance the compliance efforts.

CONCLUSION

The PTP has provided IP and other businesses with significant economic benefits. Its framework has allowed the monetization of substantially undervalued assets, the raising of essential capital and access to capital of moderate investors.

Most PTP's, as was the case with IP Timberlands, Ltd., were not formed to avoid the corporate tax. Conversely, the formation of PTP's may very well be a gain to the revenue base. Finally, well established tax rules, which have always given business the opportunity to choose which form they operate under, provide a fair and equitable means of distinguishing a corporation from a pass-through entity. To change these rules because of unfounded concerns will prohibit a form of doing business which has been found to be economically efficient and necessary.

Mr. FLIPPO. Thank you very much.

You know, last year, Treasury talked a little bit about the compliance problems that they had experienced. They are not emphasizing that so much this year, but I think compliance problems are still with us.

I wonder what your view would be—there is a concept around involving withholding at the partnership level. What would be your reaction to that? That would have a tendency to improve compliance in the filing. What would that do to your operations?

Mr. LEYDEN. I believe that the document matching program which employs the use of K-1s can ensure that our investors do comply. I would be concerned with the withholding system. First, we believe that most of our investors are small investors with relatively few holdings and may involve senior citizens, for example, who are not now subject to filing requirements.

Therefore, withholding would necessitate their filing annual returns to obtain a refund, so to speak. Also, the portion of each investor's taxable income from the partnership is generally below the level of cash distribution, and that would vary dramatically from partnership to partnership, and withholding based on a cash distribution level could involve overwithholding in some cases and underwithholding in others.

Mr. WHITEHEAD. I would agree with respect to the limited partnerships that reportable taxable income to a partnership is most times different than the cash distributed to a partner, so therefore if you are going to withhold, you don't know on what basis to withhold.

Mr. TANENBAUM. Two observations: The same issue applies to interest and dividends. I would assume that it would rise or fall with that. The other is a very candid and personal reaction. I think it is so important from the standpoint of what I perceive as a very positive future for bringing real estate into the public market so that the average investor can buy real estate as he buys other blue-chip stocks, that I would do anything for it. If you were making a deal with me, I would accept the withholding burden. I think it is bad law, though, but I would accept that burden, that is how important I think it is for this to survive.

I think you would be dooming the opportunity for people to invest in real estate if we don't permit the MLPs to go on. It hasn't worked with REITS. There is little or no withholding revenue in real estate, but we will be happy to have withholding or stand on our head just to make it happen.

Mr. FLIPPO. Mr. Leyden, you are saying you are taking something that is not liquid and making it liquid?

Mr. LEYDEN. That is correct.

Mr. FLIPPO. Mr. Andrews.

Mr. ANDREWS. With regard to the issue of eroding the corporate base as it relates to real estate in particular, should we determine as a Congress to tax MLPs, what would be the practical effect on the real estate industry? Would they not simply go to other forms of partnerships as they have historically always done?

Mr. TANENBAUM. Absolutely. There is no way that the price of liquidity can be paid by double taxation. So it would just go back to the way it was, an illiquid asset held by wealthy people, pension

funds, insurance companies and foreign investors. You are not going to have participation by the general public. The Treasury will acknowledge that.

Mr. ANDREWS. That is all I have, Mr. Chairman. Thank you.

Mr. FLIPPO. Mrs. Kennelly.

Mrs. KENNELLY. Just a point of interest. You have twice said insurance companies would be an alternative or we would go back to insurance companies. Isn't your partner an insurance company?

Mr. TANENBAUM. My company is half owned by Equitable Life and the other half by my business partners and I, yes. But we don't own the real estate that we are offering. The real estate offered is owned by the public. We are not acquiring it for our own portfolio.

Mrs. KENNELLY. But your insurance company has an interest in that?

Mr. TANENBAUM. They have an interest in the company involved as portfolio manager, in managing the properties owned by the public. Our function is to get it into public hands irrespective of what the source of the property is, we have to buy it from third parties.

And the second function that we perform is asset management with regard to the properties that are then distributed.

Mrs. KENNELLY. But an insurance company still is your partner?

Mr. TANENBAUM. Yes.

Mrs. KENNELLY. You have been very frank about coming out and saying that if we do tax MLPs it will produce no tax revenue because such legislation would simply put an end to MLPs. That is your No. 1 point.

Your No. 2 point, you say holding rental real estate in publicly traded limited partnerships will generate more tax revenue. Do I assume that means you continue to have your liquidity, and supply side economics says that if you have liquidity you do more business, therefore you get more taxes? Or do you have any other specific way more tax revenue would be generated?

Mr. TANENBAUM. There is another specific way. Our first partnership that we had offered into the marketplace trades on the New York Stock Exchange. Roughly 30 percent of the shares will turn over in the first year. For the 9½ years preceding that, that real estate was held in an illiquid format—there were no sales and no transactions. That 30 percent turnover produces revenue. They are taxable transactions on the shareholder level.

Liquidity means transactions. It is on the share transaction side, that is how the revenue would be generated. I am not talking about the further spinoffs which I think are there. I am not alluding to that at all.

Mrs. KENNELLY. You are saying there would be increased taxes—

Mr. TANENBAUM. You can put it in your eye. You are not going to balance a budget with it. It is not negative. There is some revenue to be produced.

Mrs. KENNELLY. Let me continue with a question I asked Mr. Chapoton. His statement was we shouldn't have double taxation because it does terrible things, unless we are forced to do it. We are now trying to raise revenues for the budget deficit and we are look-

ing everywhere. We just received a 291 page pamphlet giving us options with which we could raise revenues.

Is there any compromise between doing this as it was proposed, and doing nothing, because we are having these hearings on limiting the possibility of that huge revenue loss. We have time and again heard one thing was going to happen and the other thing happens. You are obviously, Mr. Tanenbaum, a cheerleader for this. It works and you like it. Are we missing something that there is something we could do that wouldn't put MLPs out of business and yet at the same time we wouldn't have hemorrhaging down the line?

Mr. TANENBAUM. I have to put it in two or three categories, one being real estate and the second being natural resources, because there has been—

Mrs. KENNELLY. What is the third?

Mr. TANENBAUM. And everything else. The everything else are the businesses that in fairness, and in fairness to the men here on my right, have been conducted traditionally in corporate form. I think that we would acknowledge, and I am sure that he would acknowledge, that there is some revenue loss. I don't believe it is a hemorrhage. Treasury apparently does. That is what you all have to find out. The time for that surge in activity to have happened would have been last year, as suggested by earlier testimony. It didn't.

Does that mean that it won't or that there will be a gradual erosion? I really don't know. I know what Mr. Mentz was concerned about in his testimony yesterday was sort of—he didn't know either, but it would be a shame if hypothetically General Motors became an MLP and then it was too late, or if some other automaker did, then are you playing on a level playing field if there is an advantage to that automaker, and not the other, and then you get into the tax policy.

I don't know whether that is the case, but in terms of the alternatives that your committee is facing, there is one issue. It is not a revenue raiser, I believe, and I think Mr. Mentz was very candid in his testimony. He is saying if you are going to make budget estimates into the future, you can't lose revenue from where you are, and he is concerned that MLP's could be a revenue loser, and it is that element that he is talking about.

I think that to try to prevent that by throwing out the baby with the bath water doesn't do anything. You are not going to collect a dollar of revenue from real estate sources if you tax MLPs as corporations. It works. There is an opportunity for something good to happen. Let it happen. If you want to do something with the rest of the companies, be my guest. I will then be here in their behalf.

Mrs. KENNELLY. Thank you, sir.

Mr. FLIPPO. We thank the panel for your responses. The committee will stand in recess until 12:45, when we will hear from the next panel.

Thank you.

[Whereupon, at 11:50 a.m., the subcommittee was recessed, to reconvene at 12:45 p.m.]

AFTERNOON SESSION

Mrs. KENNELLY. Thank you. We are going to reconvene the Subcommittee on Select Revenue Measures on the issue of master limited partnerships.

I welcome the next panel, James J. Wilson, president and chief executive officer of Interstate General Co., L.P., John Lee of the College of William and Mary, and Lewis Sandler of the National Apartment Association, also Mr. Jeff Rosenthal of the National Association of Realtors.

Thank you. We will proceed as we did this morning.

Mr. Wilson, if you will start, the other witnesses will testify and then we will have questions.

**STATEMENT OF JAMES J. WILSON, PRESIDENT AND CHIEF
EXECUTIVE OFFICER, INTERSTATE GENERAL CO., L.P.**

Mr. WILSON. I have handed in a prepared text and I will not bother you with reading from it.

Mrs. KENNELLY. It will be put in the record, sir.

Mr. WILSON. My name is James J. Wilson. I am president and CEO of Interstate General Co. Our company is in the real estate development and building business.

I started the company 30 years ago. We operated during those 30 years in four areas of the real estate business: development, home building, apartment construction, and apartment management.

During those 30 years we operated as a partnership. Some of our entities were subchapter S corporations, and we were the sponsors of approximately 30 partnerships that raised money for low and moderate income housing.

Today the company owns approximately 8,000 apartment units for low and moderate income families, and is continuing in that line of business.

In 1983-84 it was clear that our company was going to be required to raise additional equity capital if we were to continue in our line of business. At that time, being a partnership, there was a great deal of research by our attorneys as to the problems of raising equity in a partnership. We deferred doing it because the appropriate congressional committees were investigating the very question that we are now here today to discuss, and that is the difference between a private partnership and a public partnership.

It had been the Treasury's position for many years that a public partnership is, in fact, a corporation and should be taxed as a corporation. Because of that cloud, there wasn't a lot of activity in selling public units in a partnership.

However, the Congress, in its wisdom, during a 2-year period did research and came to a conclusion which culminated in the recently enacted Tax Act that they should not tax public partnerships.

As a result, in February our company signed an underwriting agreement with a group of investment bankers and sold 20 percent of our units to public unit holders and raised approximately \$20 million of equity capital which went into the enterprise and paid off our short-term bank debt.

The question that is being considered here today is basically whether the Congress, in the two years of deliberations concerning

partnerships, made a mistake in their deliberations or whether there are some new facts which would have changed their decision, had they known them.

I submit to you the following: The question of taxing partnerships was well researched and the conclusion was reached that the changes in the tax law which implemented the repeal of *General Utilities*, doctrine and addressed the question of passive income, and those two items would effectively prevent the so-called massive flow of monies away from the Treasury in the form of loss of tax revenue.

Now I will comment on one last issue, and that is the patently unfair position of the Treasury that because a partnership has public shareholders it should be taxed—a double tax, in effect—and I submit to you the following: If our company were to be subject to a double tax, I think the members of this committee would realize very simply that it would be in the best interest of the 80 percent holders, of which I am 60 percent, that it would not be a good judgment to keep the public shareholders.

So by the simple expedient of taking them out of the enterprise, we now go back to a singly taxed entity and, as a result, the Treasury is not going to get any additional income out of it. But what they have done is squeezed out the small public stockholder.

I would like to remind the committee that the last tax bill did have a provision to encourage John Q. Public to become owners of partnerships, because of the passive income provision, and we now are talking about a provision today that possibly could be adopted that would eliminate the only vehicle in which the small public investor could participate.

Thank you.

[The statement of Mr. Wilson follows:]

STATEMENT BY JAMES J. WILSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF
INTERSTATE GENERAL CO., L.P.

My name is James J. Wilson. I am president and chief executive officer of Interstate General Co., L.P., ("Interstate General").

Interstate General is a Delaware limited partnership organized on December 31, 1986. Approximately 20 percent of its outstanding units are held by the public and traded on the American Stock Exchange.

Interstate General engages in four related real estate activities: community development, home building, development and ownership of rental apartments, and management services. Interstate General is the developer of, and a leading home builder in, the planned community of St. Charles, Maryland. St Charles is located 23 miles southeast of Washington, D.C. and consists of 9,100-acre development. Interstate General manages and has general partner interests in 30 apartment projects with a total of approximately 7,000 rental units. The market Interstate General serves is primarily entry level housing and multifamily housing for low income and elderly families.

This subcommittee will hear from economists and tax theorists on the issue that it has before it today. I am an engineer by training and a businessman with over 30 years experience in real estate construction, development, and management. I wish to address the practical side of publicly traded partnerships and to relate to you what I consider to be a success story for the economy that is due, in part, to the availability of publicly traded partnerships as a vehicle for raising capital.

Interstate General's predecessor companies were owned approximately 60 percent by me and my family and 40 percent by various employees, former employees, and parties who had acquired interests as a result of business relations with the companies or personal contracts with me. Prior to the formation of Interstate General, the businesses now conducted by Interstate General attracted equity capital in various ways.

Initially, the predecessor companies were involved in the construction of relatively well-defined projects such as a single apartment project, a shopping center, or a commercial building. Equity capital for these projects was generally raised through limited partner contributions, principally by wealthy individuals or family investment companies. Minimum capital contributions of over \$200,000 were typical.

Notwithstanding the size of the individual contributions, the amount of equity raised was generally limited. Also, the equity was limited to a single project and was not available to be used for business opportunities as they became available from time to time.

In 1976, a predecessor company to Interstate General ("ISC") needed to raise capital to continue the development of St. Charles, a planned Department of Housing and Urban Development community. Again, the vehicle used to attract equity capital for the development was a limited partnership. The additional equity raised for the development was \$3.5 million. This was not sufficient to withstand the inevitable downturns in the cyclical real estate development business. There was no ready means of increasing the equity base utilizing the closely held limited partnership. For these reasons, we were forced into a debt restructuring with the Department of Housing and Urban Development early in 1983. After the restructuring business conditions improved and ISC was able to repay its remaining loans to HUD and raise limited amounts of capital through joint ventures, principally with financial institutions.

Notwithstanding these sources of capital, our business judgment was that our operations were still overly exposed to cyclical business downturns and that the cost of equity capital raised through joint ventures was higher than that available through public capital markets. Possibilities for tapping public markets included utilizing a corporation to issue shares to the public or using a partnership and admitting the public as limited partners to the partnership.

We determined that potential investors would view an investment in our business as an investment in our assets and would want to be assured of a return as the value of these assets was realized. For this reason, we decided to proceed with a public offering of limited partnership units.

Throughout this time, we closely followed legislative developments regarding the taxation of publicly held partnerships. We concluded that Congress after substantial attention had determined that publicly held partnerships would be taxed as pass through vehicles. In reliance on this and the fact that such partnerships were clearly allowed under existing law, Interstate General was organized and its units issued to the public at a price of \$9 a unit. Two million, two hundred thousand units were sold to primarily non-institutional unitholders. We now have public investors who have invested a total of approximately \$20,000,000 in Interstate General. This capital has given Interstate General the equity it needs to continue to provide housing for those markets most in need of new housing stock—entry level single-family homes and multifamily housing for low income and elderly families.

Based on this experience, I have the following observations:

(1) Publicly traded partnerships will not result in the disincorporation of American business. The repeal of the *General Utilities* doctrine places a tax cost on liquidation that would, in most cases, never be recovered by the tax savings from operating in the partnership form. Since Interstate General was organized we have considered acquisitions of companies followed by their liquidation and have rejected this as a viable approach. Also, most business that intend to reinvest their earnings will not choose the partnership form of doing business since substantial distributions would have to be made to the partners to cover, at a minimum, their tax liability.

(2) Partnerships have long been available as an investment mechanism for wealthy individuals to acquire professionally managed assets. This opportunity should not be limited to the wealthy, but should be available to all Americans. The only suitable vehicle for such investments is the publicly traded partnership.

(3) It is unlikely that any substantial revenue would be gained by taxing publicly traded partnerships as corporations. As noted above, it is unlikely that many existing corporations will convert to partnerships. The liquidation spurt of 1986 is not being repeated in 1987. As this committee knows, the liquidation of a large number of corporations in 1986 to avoid the burden of the repeal of *General Utilities* produced unexpectedly large tax revenues. Furthermore, economic activity that would generate revenue would be curtailed if the publicly traded partnership vehicle were not available.

(4) Any action taken by the Congress to curtail the availability of publicly traded limited partnerships should not apply to existing publicly traded partnerships. Expected revenues from such action would be greatly reduced or eliminated. The likely outcome will be that public investors will be eliminated through leveraged buyouts

at discount prices reflecting the reduced value of their investment when subjected to double taxation. Once again the small investor would be denied the tax advantage offered to the wealthy investor.

(5) The use of a public partnership cannot be equated with a public corporation for tax purposes under existing law. It carries its burdens as well as its benefits e.g., pension funds, tax-exempt entities and individual retirement accounts are unlikely public partnership investors because of the tax on unrelated trade or business income. Moreover, partnerships are distinctive in that partnership agreements may be structured in ways that corporate charters may not. In this regard, one notable difference is that a partnership agreement may require distributions in certain circumstances, for example, a sale of certain assets. By contrast, corporate distributions are at the discretion of the board of directors.

(6) Congress should not change the ground rules so soon after enacting the comprehensive Tax Reform Act of 1986. More time is needed to study the practical impact of publicly traded partnerships on the economy in conjunction with lower corporate and individual tax rates. In the long run, I expect that publicly traded partnerships will be an important asset for our nation's economy allowing asset based businesses to compete for capital with service and other non-asset based businesses. Congress should not take action to eliminate this asset based on ivory tower tax theory or on revenue projections that will never materialize.

It is my hope that what I have outlined above will provide this subcommittee some practical insight into the real world problems that make the publicly traded partnership vehicle a desirable form of doing business for our economy. To summarize, I believe that the publicly traded limited partnership vehicle is desirable to enable asset-based businesses access to equity capital at reasonable costs.

Mrs. KENNELLY. Mr. Lee.

STATEMENT OF JOHN W. LEE, PROFESSOR OF LAW, MARSHALL-WYTHE SCHOOL OF LAW, COLLEGE OF WILLIAM AND MARY

Mr. LEE. Thank you.

I am John Lee, a law professor at the College of William and Mary. I sort of reverse McKee's pattern. I have 13 years of practice and then I taught for 6 years. He was 13 years teaching and now is in practice. And I think we come at things from a different perspective.

We have heard a lot of talk about policy but I am not sure we have seen a lot of policy. If we look at classification criteria that are in the current 7700 regulations, we see under a deep structure analysis that the only logical difference is between an aggregate approach and a separate entity approach.

An aggregate approach tries to treat the partner just as if he owned the property directly. An entity approach says you own an interest in the entity only. Assistant Secretary Mentz would say once you have a separate entity, you have got to tax it as a separate entity.

That doesn't follow. It is a different policy question as to whether the separate entity flows through or is taxed separately. The S corporation, it flows through; look at the C corporation, it does not.

When we begin to look at trying to distinguish between those entities that are like aggregates and those that are not, factors like public trading overlap the policy factors. Yet, if you have public trading most partners do not participate. At the same time, however, you can have a partnership in which most people don't participate, in which there is no public trading, and therefore the public trading is too narrow a line.

If what you are seeking to distinguish is between aggregate and entity, the line should focus on something like "material participation," something like being in there as a partner doing things.

Probably in some small, for example, 15-person, perhaps only general, partnership you could have inactive partners that should have aggregate treatment.

When you look at current corporations, S corporations, partnerships, MLPs, what I think you see is that the MLPs and the large partnerships would fall on the separate entity side. Small C's would fall on the aggregate side.

It was frequently raised by McKee and others, should we tax the two-man partnership like the two-man corporation? That is the wrong end of the telescope. The proper question is should we tax the two-man corporation like the two-man partnership, and the answer is yes.

A small corporation in which everybody materially participates should not be able to use the 15 percent inside graduated corporate bracket versus the 28 percent or phantom 33 individual brackets, that would apply in direct taxation.

Joint committee and Treasury told us in the 1985-86 reform there was no tax policy for those graduated close C brackets. If you are looking for revenue, there may be some there. There is a universe of 4 million corporations. We now have about a million S's, I think. I don't know what the number is for large C's—surely no more than 500,000. There are 1½ million corporations with no income at all. That leaves a million closely held C's that are using the inside brackets.

If all were using them to the maximum, it would be \$5,000 per corporation, assuming 15 percent versus 28 percent—\$5,000 and change. If there is a million times \$5,000, that comes to \$5 billion. That number is probably high. But there are surely \$1 to \$5 billion out there per year.

There is no real reason for that subsidy being there besides political ways to encourage capital formation. In my experience in practice, the owners took out the salary they needed to live on, then left in in the old days \$25,000 to use the low brackets. It was simply a pocketbook to put the money in. There are things that are supposed to stop it, but they don't really.

So if we are going to be logical, we should do something like, where you are actually in there working, if you are, then you must be taxed directly; if you are not, we can have a separate entity, and that leads to the second question of what do we do with the MLP's.

Parenthetically, I think we would be doing the close C's a favor to make them pass through their income. People would use them for that \$5,000 of tax saving a year. Yet what they run into are the accumulated earnings, perhaps personal holding company, unreasonable comp problems—I have a laundry list in my statement of the problems that come up—and *General Utilities* repeal, so when they sell the business they will have a double tax. As a result, many have gone to the S's—all should go S—or something like it.

As to the large limited partnerships and the MLPs where the people do not materially participate, they should be limited to an entity approach, which means if we allow them to pass through income and loss, that is all they do. If they sell the interest, it is simply selling an interest. It is not like they sold the assets as under the aggregate approach. If someone buys, it is not like they have bought the assets as under the (elective) aggregate approach.

Many of the problems in administration as to MLP's come from attempting to use aggregate tools, allocation, and so forth, in an entity context.

As to integration, what it really comes down to—and people have talked quite a bit about subjecting these various entities to double taxes—is away from neutrality. The reality is what was decided in 1986 is that if you have active income, passive investor, that is largely held by high income individuals and tax exempts, they really don't carry their share, in my view, and therefore the tax on the corporations was to do that.

So we have a concept of schedular income. If it is active income passive investor, then it has to carry that corporate sector tax load. That tax load is not 34 percent. The corporate tax load is about 22 percent of economic income. There is not double taxation, because they don't pay out the dividends that much. It is maybe 10, 17 percent, so you can figure out what the revenue estimators have projected would come from the C sector per \$100,000 of income as to annual realization by dividend or sale by the owners of the stock.

Whatever that rate works out to be, that is the rate—plus the base 22 percent—that should apply to the economic income of the MLP if you let it pass it through. My guess is the total rate would work out to be something like 28 percent of economic income.

I am saying, let MLP's pass it through but the owners will be forced into a corporate minimum tax situation and some extra load for the fact that there would have been dividends at a small level had the MLP been a corporation, taxed at 28 percent. That would be revenue neutral because that schedular approach is the only thing that gives us horizontal equity—all of that type income is taxed the same. All income that is active with a passive investor should be taxed the same. And with that we will come closer to vertical equity, which is ability to pay. The people that own that income have the ability to pay and therefore it should be carried there.

My final point is if you are going to do this on policy, the only policy is something like material participation or pick some number, and I suspect the biggest gaming is in the close C area, not in the MLP area, and I suspect in practice the biggest gaming is the companies too big to go S, that instead do limited partnerships with their owners, various things.

On the 10th page of my statement, I point out some of the things I suspect go on there.

Thank you.

[The statement of Mr. Lee follows:]

Statement of John W. Lee

Mr. Chairman and Members of the Subcommittee

My name is John W. Lee. I am a Professor of Law at the College of William and Mary where I have taught tax law for the past six years; previously I practiced tax law for 11 years in a medium size practice specializing in tax planning for small businesses (close C and S corporations), and in the early 1970's in partnership real estate tax shelter issues. I do not currently consult and while work on this statement was funded by the Marshall-Wythe Foundation and Alumni Fund, I am representing my own views today.

I. ENTITY CLASSIFICATION

A. Multi-factor Corporate Resemblance Approach

Traditionally most authorities formulate the classification issue in terms of passthrough entity versus separate (i.e., separately taxable) entity, see Treas. Reg. § 301.7701-2; Hearings on Issues Related to Passthrough Entities before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 99th Cong. 2d Sess. 8 (1986) (Ass't Sec'y Mentz) ("Passthrough Hearings"). However, under a deep structure analysis the only universally valid functional classification distinction is between an aggregate approach and a separate entity approach (not necessarily as a separate taxpayer). Furthermore, the only determinative policy-based classification criterion is the owner's relationship to the business. The four traditional Morrissey factors (continuity of life, centralized management, limited liability, and free transferability), overly and short-sightedly mechanized by the current "Kintner" regulations, see Note, Tax Classification of Limited Partnerships, 90 Harv. L. Rev. 745, 750 (1977); Note, Tax Classification of Limited Partnerships: The IRS Bombs Tax Shelters, 52 N.Y.U.L. Rev. 405, 424-40 (1977), with the preponderance test's "thumb upon the scales" in favor of partnership status, Larson v. Commissioner, 66 T.C. 159, 185 (1976), only obliquely touch upon this relationship: essentially whether the owner actively or materially participates or is only a passive investor.

Under a deep structure analysis, material participation (or perhaps acting as the money person in a very small venture, say 15 general partners or under the Service's upper benchmark for aggregate audit, Cf. Hearings on President's 1978 Tax Proposals before the House Committee on Ways and Means, 95th Cong. 2d Sess. 5835-36 (1978), (statement of Commissioner Kurtz) ("1978 House Hearings")) is the sine qua non of "aggregate" treatment. For as the 1984 enactment of § 707(a)(2) reaffirmed the hallmark of an entrepreneur is material participation and entrepreneurial risk as to payment; under the aggregate approach the owner is treated as near as possible as an individual entrepreneur apart from the partnership, S. Rep. No. 1622, 83d Cong. 2d Sess. 99 (1954); Lane, Sol Diamond: The Tax Court Upsets the Service Partner, 46 So. Cal. L. Rev. 239, 253-61 (1973); see, Pratt v. Commissioner, 550 F.2d 1023, 1026 (5th Cir. 1977); Dep't of Treasury, The President's 1978 Tax Program 118 (January 30, 1978), reprinted in 1978 House Hearings, 95th Cong. 2d Sess. 277 (1978); Cf. Joint Committee Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 2d Sess. 238 (1984); Holiday Village Shopping Center, Inc. v. United States, 773 F.2d 276, 282 (Fed. Cir. 1985). The quintessential individual entrepreneurial characteristic is such material participation. Ideally the aggregate approach applies in virtually all aspects except audit, reporting and perhaps characterization of income. In contrast, under the entity approach the taxpayer is not treated as having any inside interest in the entity's assets, only an interest in the entity. See Holiday Village Shopping Center, Inc. v. United States, 5 CL Ct. 566, 570 (Cl. Ct. 1984), aff'd, 773 F.2d 276, *supra*. A passthrough in such an entity is limited to a pro rata share of income and loss and tax-free withdrawal of investment and retained earnings and no more, i.e., essentially Treasury's preferred approach to Subchapters K and S, see Passthrough Hearings, supra at 15-16, 36. These traditional classification criteria do not speak in any way to whether the entity should be taxed separately or should passthrough its income/loss and permit tax-free withdrawal of investment and earnings. Whether an entity should be able to passthrough poses different policy questions discussed below.

The case-law matrix, which existing corporate resemblance regulations mechanized, rests upon the franchise privilege-benefit rationale for corporate taxation. Compare Morrissey v. Commissioner, 296 U.S. 344, 359 (1935) with Flint v. Stone Tracy Co., 220 U.S. 107, 162 (1911), and corresponds in large part with Congress' early understanding of the business purposes for incorporation (limited liability and continuity of life), Scallen, Federal Income Taxation of Professional Associations and Corporations,

49 Minn. L. Rev. 603, 613 (1965). Nevertheless, only "centralized management," as reinterpreted in the June 1986 Passthrough Entity Hearing Pamphlet, Joint Committee Staff, Federal Income Tax Treatment of Pass-Through Entities, 99th Cong. 2d Sess 13 (1986), of the 4 factors functionally corresponds with the deep structure policy of basing aggregate passthrough treatment on entrepreneur activities. Reflection on large service partnerships proves this point. Conversely, commentators and witnesses at various hearings have argued that most, if not all, of the 4 traditional corporate advantages and hence characteristics are functionally in fact usually not available to a close corporation and its owners, Passthrough Hearings, *supra* at 19, 28 (Ass't Sec'y Mentz); *Id.* at 43, 51 (McKee & Keller); which probably constitute approximately 90% of all corporations. I agree; most close C corporations exhibit none of Reg. § 301.7701-2(d)'s four corporate characteristics: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of unit of ownership.

First, notwithstanding the perpetual continuity of a corporate charter, when the principal dies, the business will terminate or be sold unless management successors have been or can be soon arranged. See Kessler & Yorio, Choosing the Appropriate Form for the Small Business, 1 Corp'n L. Rev. 291, 298 (1978). In close C corporations with very narrowly held stock, key shareholders tend also to constitute the board and key officers—a pattern of overlapping positions reaching its extreme usually in sole shareholder operations where complete identity between the board, officers and owners commonly exists. Thus, centralized management is non-existent in most close corporations. Limitation of liability is often a chimera as well for close C's. Significant third party creditors (except perhaps in real estate ventures) usually require guarantees by principal shareholders and their spouses. Passthrough Hearings, *supra* at 19 (Ass't Sec'y Mentz); Kessler & Richmond, Is C Corporation Obsolete for the Small Business?, 7 Corp'n L. Rev. 293, 294 (1984). Furthermore, an active shareholder may be personally liable for his/her own torts in the scope of his/her "employment" and possibly in supervising others. Kessler & Yorio, *supra* at 302-04. Finally, the assets of the corporate business itself, always subject to the entity's liabilities, are often the principal asset of the entrepreneur. Free transferability also misses the mark in a close C where the real problem is finding any secondary market at all for minority close C stock. Here a (put-option) buy-sell with the corporation and/or co-shareholders and right of first refusal are quite the standard.

Conversely, by skilled drafting most of the big 4 corporate advantages can be obtained by entities that traditionally have been viewed as partnerships, particularly large limited partnerships, i.e., over 15 partners, see 1978 House Hearings *supra* at 277. Until Reg. § 301.770-2(a)(3) instituted (in 1960) the ill-fated preponderance (more than 2 out of 4 "corporate" characteristics) test, certainty as to classification was virtually impossible. Most suggestions for a multi-factor approach recreate such uncertainty, particularly the Larson call for de-mechanization, unless the thumb on the scales is simply reversed to apply a preponderance test as to non-corporate status. But the most serious defect in the current classification regulations is that the resemblance-characteristics multi-factor approach has never been clearly directed at any underlying identifiable policy, unless certainty in itself is viewed as a policy—as some do indeed argue. See Passthrough Hearings, *supra* at 28; Note, 52 N.Y.U.L. Rev. *supra* at 440.

Commentators have advocated myriad changes to the multi-factor approach, generally settling on one factor or another as determinative, either (a) limited liability, Note, 90 Harv. L. Rev. *supra* at 757 (personal liability); Keyser, Publicly Traded Limited Partnerships: The Treasury Fights the Wrong War, 36th Inst. on Oil & Gas Law & Tax'n 10-1, 1-18 - 10-19 (1985) (recourse liability with substantial general partner); Hyman & Hoffman, Partnerships and "Associations": A Policy Critique of the Morrissey Regulations, 3 Real Estate Tax'n 377, 381, 397 (1976) (state law characterization should be determinative) (future test should be reasonable one, "stating the number of owners and types of complexities of capital interests. . . [permitted for passthrough status]"); Postlewaite, Dutton & Magette, A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Georgetown L.J. 396, 459 (1987); Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 897 (1987); or (b) whether the owners' interests are publicly traded, see Outlaw v. United States, 494 F.2d 1376 (Ct. Cl.), cert. denied, 419 U.S. 844 (1974) (other factor); Peel, Definition of a Partnership: New Suggestions on an Old Issue, 1979 Wisconsin L. Rev. 989, 1012-13, 1016 (rough, rule of thumb) (any 3 out of 4 or limited liability plus public trading); ALI, Federal Income Tax Project Subchapter K: Proposals on the Taxation of Partners 392-93 (1984). None of these proposals accurately distinguish between an (a) aggregate or collection of individuals and (b) an entity. Nor does reworking the relative weight to be given the 4 traditional corporate resemblance factors, and including other

factors, such as public trading, all as suggested by the Tax Court in *Larson v. Commissioner*, 66 T.C. 159 (1976), promote predictability or the underlying policy of aggregate treatment only for entrepreneur characteristics.

B. Proposed Classification Standard: Relationship to the Entity's Business

Both the Treasury position at the Pass-Through Hearings last Summer and the accompanying Hearing Pamphlet attempt to base pass-through treatment on the "relationship between the entity and its owner," Passthrough Hearings, *supra* at 11; Pass-Through Hearing Pamphlet, *supra* at 13-14. However, only lack of involvement in management or operation corresponds with the underlying policy of requiring separate entity status where most owners do not actively participate. If substantially all of them are not involved in the entity's management or operations, no functional basis for an aggregate approach exists; policy thus calls for an entity approach. Conceivably, albeit not unlikely, an entity with a large number of owners and publicly traded ownership interests may have a large number of owners involved in the management or operations. More significantly the absence of these factors does not guarantee material participation. Thus, Treasury's publicly traded standard is clearly too narrow leaving undisturbed, (a) the more serious debt backdoor integration, see Canellos, Corporate Tax Integration: By Design or By Default, 35 Tax Notes 999, 1002, 1007 (1987); Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 890, 898 (1987), and (b) gamesmanship in a close, but large C with "spin offs" through large non-publicly traded limited partnerships, which functionally resemble MLP's and large C corporations. See Hearings on Reform of Corporate Taxation Before the Senate Committee on Finance, 98th Cong. 1st. Sess. 160, 365, 375 (1983) (statements of John S. Nolan, Southwest Realty, and Timber Realization) ("Senate Subchapter C Hearings"). This Treasury surely added the frequent change of ownership and access to capital markets factors just in order to narrow the targeted group effectively to master limited partnerships, and not all large limited partnerships. Former Assistant Secretary for Tax Policy Ron Pearlman believes that publicly traded interests indicates corporate status but is not be determinative. See Sheppard, Rethinking Limited Partnership Taxation, 30 Tax Notes 877, 879 (1986). In the past Treasury has opposed such a piecemeal approach to classification. See Senate Subchapter C Hearings, *supra* at 11, 14-15 (Pearlman); Cf. 1984 House Tax Shelter Hearings, *supra* at 40 (Asst. Sec'y John E. Chapoton). But see Dep't Treasury President's 1978 Tax Program at 117-20 (1978), reprinted in 1978 House Hearings, *supra* at 276-79.

While publicly traded interest practically means that the majority of the owners do not materially participate, and hence should be limited to an entity relationship; the same cannot be said about the other single classification factor currently advocated, namely limited liability. An entity in which substantially all of the owners materially participate in the business could have nonrecourse financing, or more likely not have any substantial debt, e.g., a service organization, and insurance against all substantial risks. Indeed Congress itself in § 469 recognized that liability and material participation were not synonymous. "The distinction that the Committee believes should be drawn between activities on the basis of material participation bears no relationship to the question of whether, and to what extent, the taxpayer is at risk with respect to the activities." S. Rep. No. 313, 99th Cong. 2d Sess. 717 (1986). Moreover, the absence or presence of liability does not address the underlying aggregate issues. Compare *Id* at 717 n.6.

In fact, a functional aggregate analysis could readily use the new "material participation" standards of § 469 as a starting point in determining whether the entity should be treated as an aggregate of its owners. The "material participation" standard also looks at the relationship of the owner to the activity of the entity. "The relationship to an activity of an investor who does not materially participate may be little different from the relationship of a shareholder to a corporation." S. Rep. No. 313, *supra*. The actual approach probably should not track the detailed rule after detailed rule applied to passive activity losses. For example, the automatic PAL exclusion of real estate from material participation, except in narrow circumstances, probably is inappropriate. Conversely, limited partnership status, regardless of public trading, functionally appears an interest that does not materially participate and, hence, would be limited to an entity approach. Material participation for this purpose should not be limited to performance of services by the owner. In a small enough operation, for example, the classic moneyman and service provider, a general partner moneyman should be deemed to materially participate. Probably the benchmark for such deemed materially participation should be 15 partners including the investor (general) partners.

Moreover, following through logically, most closely held C corporations would functionally be aggregates and, hence, should not be entitled to defer taxation to the owner until distribution of profits. Treasury would avoid this little problem (encompassing probably 90% of all corporations) by granting automatic non-corporate status to a general partnership and automatic corporate status to a formally organized corporation. Passthrough Hearings, supra at 28, in effect only applying the relationship to the entity analysis to limited partners, indeed, publicly traded limited partnerships or Master Limited Partnerships.

In the context of the MLP issue currently before this Subcommittee, the first policy question as to a Master Limited Partnership is whether its owners should be entitled to aggregate treatment or be limited to separate entity treatment. Assuming that the bulk of the owners in a Master Limited Partnership do not materially participate, such Master Limited Partnership should be treated as a separate entity. Such owners are not entrepreneurs, they are mere investors. Thus, no inside basis adjustments, fragmentation as to sale or purchase, etc., should be available. The same denial of partnership aggregate pass-through should apply at least to large (over 15 partners) limited partnerships in which the majority of partners (by percentage interest) do not actively participate. Passthrough of income or loss is a separate issue as indicated above, and is discussed below. Ironically, the uncles, if not the fathers, of current subchapter K anticipated that small partnerships would opt for aggregate treatment and intended the entity election aspects of current subchapter K for larger partnerships. Hearings on General Revenue Revision before the House Committee on Ways and Means, 83rd Cong. 1st Sess. (Part 2) 1370 (1953) (statement of Mark H. Johnson, on behalf of American Bar Association) ("1953 House Hearings"); Jackson, Johnson, Surrey & Warren, A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft, 9 Tax L. Rev. 109, 129-30 (1954). My suspicion is that the present situation in practice inappropriately is completely the reverse. Cf. Canellos, supra at 1006; Leonard, supra at 896. We need to get back to the basics of aggregate treatment.

II. SEPARATE TAXATION OR PASSTHROUGH: INTEGRATION

A. Introduction

If a majority of the partners in a partnership actively participate in the entity's business, the partnership and its partners should be permitted aggregate passthrough tax treatment (the rationalization of current subchapter K). Probably the same treatment should automatically be available based upon a size limitation, say 15 partners (perhaps limited to general partners). Presumably, also, such a partnership and partners would be entitled for "simplicity" to elect one time for entity-conduit or entity passthrough tax treatment (the rationalization of current subchapter S). At the same time, if a majority of the shareholders in a (close) C corporation actively participate in the entity's business, the C corporation and its shareholders should be taxed under a passthrough regime: elective (a) aggregate passthrough or (b) entity-conduit or passthrough. Again, a mandatory passthrough rule probably should apply to close C corporations with under 10 or 15 shareholders (perhaps treating economic family and business groups as a single shareholder). The practical effect of a mandatory passthrough could be easily obtained by (a) eliminating the graduated close C tax brackets under the present regime, and (b) easier election of pass-through treatment.

Large limited partnerships, including but not limited to Master Limited Partnerships, and (large) C corporations conducting a big business (over \$100,000 net profits) in which the majority of the owners do not materially participate should be restricted to a separate entity approach. Under the current system of corporate and partnership taxation this would mean the current C double taxation approach. The possibility of entity-passthrough or "integration" for such large entities is discussed below.

B. Close C Corporation: Mandatory Integration

1. Mandatory Passthrough of Income and Loss at Entrepreneur's Rates

Since there is no policy reason for taxation as a separate entity to produce less taxation than direct taxation, particularly where the owners materially participate, in such close C's at least passthrough of income and loss should be mandatory to end the inside tax shelter. Lee, Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions from Overly Processed Corn Products, 30 Tax Notes 1375, 1384 n.39 (1986) (small C's); House 1978 Hearings, supra at 3518-19; 3 Tax Revision

Compendium, *supra* at 3532 (statement of Dennis Gaffney on behalf of the American Taxation Association Committee). See Canellos, *supra* at 1007 (elective); Panel Discussions on Income Tax Revision before the House Ways and Means Committee, 86th Cong. 1st Sess. 855 (1960). Earlier policy saw the lower inside rates as a necessary incentive to capital formation and as an answer to excessive individual rates, e.g., 91%. See Joint Committee on Economic Report, *The Federal Revenue System: Facts and Problems*, 84th Cong. 1st Sess. 682-88 (1956); *Hearings on Federal Tax Policy for Economic Growth and Stability before the Subcommittee on Tax Policy before the Joint Committee on the Economic Report*, 84th Cong. 1st Sess. 529-31, 555-56, 587 (1956) (colloquy between Senator Goldwater and Harry Rudick); colloquy between James Hall, Edwin Cohen and Chairman Mills; see also Senate Subchapter C Hearings, *supra* at 160 (statement of Nolan).

Due to the transactional tax costs to such inside shelter (particularly the repeal of *General Utilities*) discussed below, mandatory passthrough now would actually do small business a favor—which they will need. In 1982 there were 564,219 S corporations (260,558 reported a net loss, probably reflecting traditional preferred use of S for start-up ventures). See *Hearings on High-Income Taxpayers and Related Partnership Tax Issues before the House Ways and Means Subcommittee on Oversight*, 99th Cong. 1st Sess. 73 (1985) (statement of Asst. Sec'y Pearlman). In the last 2 months of 1986 and first two weeks of 1987 220,000 S elections were filed. See Leonard, *supra* at 894. The million or so other close C corporations will find that the 2-year transition rule for close "small" C's as to § 1374's 10-year taint contains an exception for built-in ordinary income, e.g., profits, which is subject to double tax as the inventory turns or accounts receivable are collected, albeit more in the latter, than the former, see Volpi, *S Corporations Before and After the TRA*, Tax Adviser 365, 372 (June 1987).

Additionally, sales of larger close C's (before or after converting to S status) trigger, directly or indirectly, double taxation on the built-in appreciation rarely corresponds to the close C inside tax shelter previously enjoyed. That tax shelter was the lower C inside rates, plus deferral. Assume that the C's inside rate was 25%. (The minimum inside bracket varied from 30% to 15% under the 1954 Code). Assume also the owner's marginal rate was 50% (that too varied from 91% to 50% under the 1954 Code, but the base was frequently eroded, even totally). If the entity has \$75 E&P and we assume \$25 in close C entity-level taxes, then hypothetical grossed-up earnings are \$100. Had the owner earned this \$100 directly, he/she would have paid \$50 in taxes. Borrowing from the employee benefit tax area, the deferral privilege should cost 10% of the deferred amount (10% x \$75). So the hypothetical tax would be \$57.50 with a credit for the \$25 deemed paid by the entity. So the proper net tax to purge the C E&P is \$32.50, which is approximately 45% of accumulated E&P. I might point out, close C witnesses scuttled in 1982 a similar 20% toll charge (20% of excess of inside basis over outside basis) for C to S conversion ably presented by Professor Ginsburg (and adopted by the ABA Section of Taxation) to the House Ways and Means Committee in 1982. See *Hearings on H.R. 6055 (Subchapter S Revision Act of 1982) before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee*, 97th Cong. 2d Sess. 98-99, 118, 151-53, 201, 206, 209-10, 216-35 (1982). Whether the newfound enthusiasm for integration can swallow this toll charge this time is another story. An answer might lie in prorating the toll-charge over say 5 years as Professor Ginsburg also suggested. *Id.* at 225-26. Under this model, basis step up would be proportionately limited this time year-by-year to the percentage of the tax paid. Alternatively, borrowing from the § 108 elective regime and Professor Ginsburg's observation that a basis reduction is equivalent to an increase in future income, *id.* at 217, former C's could reduce basis by an appropriate charge instead of an imputed "realization" toll charge.

Under such mandatory passthrough, close C's should be entitled to elect an aggregate (K model) passthrough, as witnesses have often suggested, see *Passthrough Hearings*, *supra* at 95 (statement of John Pennell); *Hearings on General Revenue Revision before the House Committee on Ways and Means*, 85th Cong. 2d Sess. (Part 1) 47 (1958) (colloquy between Congressmen Koegh and Sheehan); 1953 *House Hearings*, *supra* at 1391 (statement of American Institute of Accountants); (the Senate in 1954 in proposed § 1351 would have allowed a qualifying corporation to elect tax treatment as a partnership, with (a) a 10 shareholder active participant limit, (b) restrictions on non-individuals and non-resident aliens, and (c) a single class of stock, S. Rep. No. 1622, 83d Cong. 2d Sess. 452-53 (1954) (the provision was stricken without explanation in Conference), as well as probably an S or entity pass-through model.

2. Conventional Close C Tax Planning

Conventional wisdom advocated "manipulation" of (a) outside individual income rates as to "compensation" from the enterprise and inside graduated C corporate rates on its retained income in the small closely-held corporation context, in order to obtain an "inside tax shelter." Lee, *supra*. This abuse was pointed out to Congress long ago. 3 Tax Revision Compendium, Compendium of Papers on Broadening the Tax Base Submitted to the House Committee on Ways and Means at 1686-87 (1959) (statement of Janin); see also Hearings on the Revenue Act of 1978 before the Senate Committee on Finance, 95th Cong., 2d Sess. 136 (1978) (Sec'y of Treasury Blumenthal) ("We think this graduation at the bottom [of the inside corporate tax rates] is really what has been referred to in the literature as the ultimate tax haven, tax shelter, for a high income individual"). Thus, the regular C corporation was "ultimate tax haven, tax shelter"—under the 1954 Code for the closely-held business annually retaining \$100,000-\$200,000 in profits and paying out the rest of its profits as hopefully deductible compensation to principals. See Starr, S. Corporation: Is it the Right Choice?, 43 N.Y.U. Inst. on Fed. Tax. 5-1, at 5-36 (1985). See generally Watkins & Jacobs, Closely Held Business: Tax Planning After ERTA, 9 Tax Adviser 516 (1982). Such manipulation, coupled with a date of death step-up in basis at the owner level in the corporate stock upon his/her death, § 1014(a), and under the 1954 Code codification of General Utilities non-recognition at the inside corporate level on inside gain upon a taxable disposition of the C corporation or its assets, §§ 336, 337 and 338, meant as a practical matter that use of a C corporation, far from resulting in double taxation on corporate income from operations and appreciation in assets, often actually yielded under the 1954 Code less total taxes at the combined shareholder and corporate levels, than if the principal had not incorporated the venture in the first place. Sen. Fin. Comm. Staff, Preliminary Report, The Reform & Simplification of the Income Taxation of Corporations, S. Print 95, 98th Cong. 1st Sess. 88 (1983). This absurd result can not be justified by any tax policy. *Id.* at 88 (Other than capital formation as discussed above, and surely better ways exist for that purpose). The real issue, therefore, under the 1954 Code was not double taxation, but whether the Service would collect one tax one time. The amount of this tax expenditure could be as high as \$5 billion a year (1,000,000 close C's x \$5,000 (\$50,000 x 13% spread)) if so, it should be better targeted, e.g., to minority businesses, etc.

3. Hidden transactional costs under the 1954 and 1986 Codes.

Such use of a C corporation as an inside tax shelter entails, however, substantial transactional tax costs, and is the source of much, if not most, of the 1954 Code corporate shareholder tax complexity and endless administrative controversy in the corporate and shareholder taxation arena, which continues under the 1986 Code. For example, balancing the income from the venture between compensation to principal and retained taxable income not exceeding the lowest corporate graduated brackets generates the problem of "unreasonable compensation" not deductible to the corporation. Retention of corporate earnings to obtain the lower inside tax bracket rather than payment to shareholders, triggering true double taxation, poses "accumulated earnings tax" problems, see Watkins & Jacobs, *supra*; Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reform before the House Committee on Ways and Means, 98th Cong. 2d Sess. 156 (1984) (statement of Martin Ginsburg) (hereinafter "Tax Shelter Hearings"); with clumsy retention of earnings for a personal investment program, personal holding company tax problems instead. Furthermore, splitting personal service income between a close C and the shareholder-employee gives rise to intense § 482 deemed arm's length reallocation of income or deductions problems. Even if the retention of profits at the corporate level is ultimately respected, attempts to realize the economic benefit at the shareholder level prior to the sale of the business often creates new tax problems, e.g., whether (a) withdrawals structured as "loans" constitute constructive dividends (a recent study by my colleague Jayne Barnard demonstrates that in her sample of previously close corporations engaged in an initial public offering, nearly 50% had made substantial loans during a 3-year lookback to their officers or directors; the comparable figure for publicly held corporations is 16%), (b) sale/exchange or dividend treatment applies to redemption payments upon retirement, as well as, (c) whether the "collapsible corporation" provisions will apply. The latter problem areas (b) and (c) should disappear, except for basis recovery in redemptions, if the 1988 elimination of the capital gains preference actually comes into effect and remains in effect. Finally, offsetting the use of a C as an inside tax shelter was one of the primary (post-facto) policy justifications for the 1986 repeal of General Utilities. See Sheppard, General Utilities Repeal, 33 Tax Notes 183 (1986).

The 1986 Code makes four major changes and one perhaps minor exception to a major change affecting choice of tax entity for small businesses. See generally Bogdanski, Closely Held Corporations, Using Corporations for Tax Savings--A Reappraisal, 14 J. Corp. Tax. 160 (1987). Davis, Effect of the Tax Reform Act of 1986 on the Choice of Entity Decision, 6 Tax Mgm't Weekly Report 414 (April 6, 1986).

a. The lowering of the individual income tax rates lessens but does not eliminate the spread between the graduated inside corporate tax bracket for small corporations (e.g., 15% up to \$50,000) and the maximum outside shareholder level tax bracket. Moreover, the maximum inside corporate tax bracket of 34% is greater than the maximum individual tax brackets of 28% and "phantom" 33%. However, some still recommend the inside shelter of a C. See, e.g., Kramer, Take a Hard Look Before Electing S Corporation Status, 1 Tax Times 14 (Dec. 1986).

b. The repeal of General Utilities, and perhaps even more significantly the imposition of new restrictions on C to S conversions to backstop such repeal, impose a true second tax upon disposition of a stock or assets of C corporation or its assets by an S in which C E&P has been retained. This repeal may be viewed as a surrogate tax for the prior use of the close C inside shelter. Sheppard, *supra*, 33 Tax Notes 184. I am indebted to Edwin Cohen and Samuel Thompson for the insight that the repeal of the General Utilities shield in this context acts, however, as a "rogue judge," levying a penalty or toll charge often disproportionate to the crime. As a practical matter the new C to S conversion penalties and the ordinary component of the 2-year transition rule in their present form, will probably eliminate the post-1986 use by a close C corporation of a S corporation election to avoid accumulated earnings tax and the more intense maximum corporate rate once substantial profits have been retained and substantial profitability from operations is attained—a common 1954 Code technique.

The practical impact of the General Utilities Repeal is that a large C (over \$10,000,000) must face an immediate inside (§ 336) and outside tax (§ 331) upon conversion directly to passthrough status as in a Master Limited Partnership. As a practical matter, therefore, this is unlikely to occur. See Passthrough Hearings, *supra* at 38, 50. As discussed below, many partnership spin off techniques are being designed to pass future appreciation and income attributable thereto directly to the owners or others.

For a small C corporation, i.e., under \$5,000,000 or subject to old and new §§ 336 and 1374, etc., for \$5,000,000 to \$10,000,000, the S mechanism offers the best passthrough. However, the practical effect of new § 1374 and the 2-year transition rules for close, "small" C's converting to S is that while the double tax on appreciated investment or operating assets can be avoided by waiting out the 10-year taint of new § 1374 as to ordinary income assets or three years as to capital gains assets for transition rule S's under old § 1374 (or clever use of installment reporting), the practical toll charge is a second tax on built-in gain in operating profits at conversion. Ordinary income is not subject to any transitional rule and whether in the form of accounts receivable of a cash basis taxpayer or inventory of an accrual basis taxpayer are subject to one degree or another to new § 1374's double taxation. See Joint Committee Staff, General Explanation of the Tax Reform Act of 1986, 100th Cong. 1st Sess. 344 n.89 (1987). Arguably in a services enterprise the double taxation sting can be avoided by "offsetting" compensation payments to the principals, subject to reasonable compensation limitations.

In my view, current § 1374 and the transition rule constitute inappropriate models for dealing with wholesale conversions from close C to S (as is full recognition inside and out upon conversion of a close C to a partnership), particularly where the owners materially participate. The appropriate toll charge (for purging C E&P) is discussed above at p. 5 of this statement.

c. Eliminating the capital gains preferential tax rate affects the ability of the shareholders to withdraw the retained earnings at a preferential outside rate through redemption or sale. But 28% is not that much greater than 20%.

d. Additionally, the 1986 Code corporate minimum tax applicable to C corporations is in some cases more restrictive than the minimum tax applicable to non-corporate partners and shareholders in S corporations, particularly as to book income, whatever that means.

c. The 1986 PAL provisions (\$ 469), when fully phased in, largely will end the use of (limited) partnerships and S corporations to conduct a "passive loss" generating activity or traditional tax shelter, since they pass such passive losses through (retaining the same character) to their shareholders or limited partners. However, a closely-held, non-services C corporation can offset "business income," but not portfolio income, with passive losses, § 469(e)(2), an anomaly to the extent most owners of close C's materially participate; the current portfolio income exception does not go far enough. But again, once you put a passive loss activity in a corporation, you create a new set of hidden transactional tax costs, e.g., evidence of bad motive for accumulated earnings tax and double tax upon distribution, etc.

A mandatory passthrough of income and loss as to close C corporations in which a majority of the shareholders materially participate would simplify greatly tax administration and life for small businesses. Moreover, with the elimination of the close C bail-out pressure, the path would be open for substantial simplification of Subchapter C. Cf. Senate Subchapter C Hearings, *supra* at 230-31; Mill's Tax Revision Hearings, *supra* at 855, 885-89.

C. Publicly Traded Entities

I. Introduction.

From 1954 to until 1981 here too was a tax shelter for high income taxpayers subject to 70% to 91% when the nominal big C corporate rate was around 50%. See Mills Tax Revision Hearings, *supra* at 861, 863-64, 903-04; 1978 House Hearings, *supra* at 3523-24 (Gaffney). The true inside effective rate was much less during this era due to use of preferences and/or debt. Moreover, low capital gains rates at the shareholder level or date of death step up could result in little or no income tax compared with direct taxation. Skillful tax planning could make the income tax as to active business income earned in corporate form as voluntary as the estate tax. Truly, the question was not double taxation but instead severe undertaxation. Now the public C deferral-shelter has disappeared: a "nominal" flat 34% inside vs. flat 28% (after 5% clawback hump at \$50,000 to \$150,000 of joint income). The reality is a little different: With preferences and debt eroded corporate tax base, the corporate effective rate is brought up to the low 20's only through the corporate minimum tax and BURP.

The "corporate sector tax," being borne in the short-run by big C shareholders and in the long-run probably by the owners of capital in general, to that extent adds some progressivity as to high income individual and tax-exempt shareholders. Thus, a corporate sector tax adds some vertical equity, i.e., progressivity based upon ability to pay, to the current system. More significantly, at least in a political sense, is the operative fact that the increase in the corporate sector tax (as well as the pre-1986 Act estimated corporate sector tax) was clearly the glue that held together the 1986 Act with its goal of an equal percentage reduction income class-by-income class on the individual side, largely equalled by a corporate sector increase (although half of the corporate increase consisted of timing changes). Congress and Treasury should not now change the mix. And it does not appear that either intends to. If the "corporate sector tax" is functionally translated as a tax on "schedular corporate sector income," i.e., active business income earned by an entity in which a majority of the owners do not actively participate, then horizontal equity in terms of treating all such schedular income equally and the above described politics demand that any form of large separate entity integration for large C's, MLP's or large limited partnerships—active businesses with passive owners—must be revenue and distributionally neutral.

Integration of large C corporations is not now politically feasible (revenue and distributionally neutral or not) due to the continued hostility of corporate management and tax-exempt shareholders to any form of full integration. The former, because they like being money managers; the latter either because they don't understand the current incidence of corporate taxation or because it would be the first step to imposing some income tax on tax-exempt holders of both equity and debt instruments to maintain a level playing field (otherwise the bias in the present system towards debt would continue as to tax-exempt debt holders). While populists may now, as I do, unlike earlier favor integration of large C's (provided that the projected corporate sector tax is borne directly by the owners as in an expanded entity-conduit regime, probably through a non-refundable credit), compare Sheppard, *Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax*, 27 Tax Notes 637 (1985) with 1978 House Hearings, *supra* at 3504, 3507, 6107-09 (statement of Sheldon Cohen); the political balance still appears against big C integration; Leonard, *A Pragmatic View of Corporate Integration*, 35 Tax Notes 889, 895 (1987), Cf. Hearings on Reform of Corporate Taxation Before the Senate

Finance Committee, 98th Cong. 1st. Sess. 2 (1983) (statement of Chairman Dole; "it is pretty clear to this Senator that politics and economics will prevent any radical change [such as abolishing the corporate level tax or taxing shareholders on all corporate income without regard to its distribution] in the near future."), as this Subcommittee was told by Treasury last summer.

As to "Master Limited Partnerships" clearly the current classification and tax treatment as an "aggregate" passthrough entity is inappropriate from a policy perspective because most if not all owners of MLP's do not materially participate in the entity's active business. Therefore policy mandates separate entity treatment rather than an aggregate passthrough treatment. This raises the question then whether the MLP as a separate entity should be entitled to passthrough or conduit treatment in the form of full or partial integration. First the current non-partnership passthrough models (other than S corporation) do not appear appropriate, although I do not profess to any special expertise as to regulated investment companies, real estate investment trusts, and their newer analogues. It appears to me however, from testimony in prior hearings that the hallmark of passthrough as to such entities is that the income of the entity be passive. Here we are concerned with active income/passive investor. Nor does the trust model appear applicable, since historically here too the distinction was between active income and passive income; and, more significantly, most trusts similar to Master Limited Partnerships would fall on the separate entity side of classification. Recall that Morrissey itself involved a business trust.

Subchapter S indeed is the appropriate passthrough entity model for MLP's, i.e., entity passthrough, not aggregate passthrough. However, in order to maintain (a) the political trade-offs of the 1986 Code and (b) horizontal and vertical equity through corporate sector schedular income, any such passthrough income must in a schedular fashion bear the appropriate estimated corporate sector tax. Compare Canellos, Corporate Tax Integration: By Design or By Default, 35 Tax Notes 999, 1007 (1987). Moreover, allocations under such a separate entity passthrough would follow the "more rigid" unit of ownership model and no inside basis adjustments or special allocations would be permitted.

2. Schedular Passthrough or Double Taxation.

Since progressive rates have been compressed, horizontal and vertical equity with passthrough of separate entity income, i.e., MLP's and certain large limited partnerships can only be obtained through passthrough of "schedular income" (active business and inactive unit owners) which carries with it at least the targeted "corporate sector tax" burden as to such income, say above \$100,000. I call this the "F.N. Bard" proposal, in honor of the Illinois rancher, farmer and small manufacturer who proposed in the 1953 House Hearings (as well as on many other occasions) that partnerships be allowed to elect (then lower) C corporation rates as to business income, with regular higher individual rates on portfolio income, 1953 House Hearings, *supra* at 1363 (statement of F. N. Bard)—a schedular income idea before its time and partially enacted in little used and now repealed Subchapter R. Of course, Bard wanted the inside C shelter so a partnership could compete with corporations. *Id.* at 1368.

Simply taxing such "corporate sector" income directly to the individual partners in MLP's and large limited partnerships at 34% on the existing corporate sector tax base, probably would produce only an effective rate of say 22% on economic income (and only then if corporate-like minimum tax and timing shifts apply) and at the same time would ignore the usually deferred and minimal "double taxation" at the non-tax exempt shareholder level on ultimate owner "realization" through "dividends," sale or liquidation, etc. The more simple and probably most equitable "integration" treatment of MLP's and large limited partnerships and their partners as to such "corporate sector" schedular income (active business, passive owners) would be to provide an election: (1) treatment in all ways as a large C with an entity level 34% rate on the existing corporate base with an inside corporate-like minimum tax, plus an outside shareholder level 28% tax as to taxable realizations by partner-owners, or (2) an entity-conduit integration along rationalized S model lines with preferably a 28% (or phantom 33%) tax at the "partner" level on the entity's economic income, i.e., without preferences or timing distortions, regardless of whether distributed, with a basis increase for subsequent tax-free withdrawal at the partner level. Such treatment of MLP's and large limited partnerships could be a model for ultimate integration of large C's were the politics ever to change. Remember that they thought that there would be no 1986 Code.

The losses of such a separate active business entity with passive owners would not shelter other income of the taxpayer partner, whether from services, portfolio, or similar non-aggregate passthroughs. Treasury has ample authority under current § 469(k)(3) to handle this problem without further legislation. See *Passthrough Hearings*, *supra* at 13-14 (awareness by Treasury of MLP's as method of gaming PAL rules unless special precautions are taken, viz § 469(k)(3)). Therefore, merely providing that MLP's income is portfolio income for purposes of the PAL provisions is not really a compromise position by the industry. Treasury already holds that card.

If such schedular passthrough of income or full integration at least as to income is not feasible, politically or administratively, then MLP's and their partners and large limited partnerships and their partners should both bear the current subchapter C double taxation regime as to "corporate sector income."

III. USE AND NATURE OF MLP'S

Commentary and witnesses in prior hearings have pointed out that the revenue amount involved in taxing MLP's as large C's is not significant, and there is no widespread reincorporation of existing large C corporations. However, under the current rules taxpayers with expert advice will structure new ventures, as in the high tech area, as limited partnerships, see *Passthrough Hearings*, *supra* at 38-39 (statement of Assistant Secretary Mentz), partially in anticipation of the entity going public without triggering a post-General Utilities repeal tax as to appreciation in the entity's assets. This alone makes the playing field unequal. *Id.*

Commentators and witnesses at other hearings have also explained that under the current partnership rules (especially special allocations) MLP's and limited partnerships will be used to "spin off" portions of a business of an existing large C corporation through transfer of such portion to a limited partnership in exchange for a general partnership interest. See Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Drafting Partnerships onto C Corporations, Running Amok with the Master Limited Partnership Concept and Generally Endeavoring to Defeat the Pension of the Draftsmen of the Repeal of General Utilities*, 64 *Taxes* 962, 967, 975 (1986); *Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms Before the House Ways and Means Committee, 98th Cong. 2d Sess. 469-70* (1984) (statement of David Glickman); *Senate Subchapter C Hearings*, *supra* at 518-21 (*Id.*); Cf. Sheppard, *Walk this Way: Taxing Publicly Traded Limited Partnerships as Corporations*, 35 *Tax Notes* 86, 87 (1987). In this least-abusive spin-off the limited partnership interests are either distributed to shareholders or sold to the public. In a more sophisticated version, variations of partnership "estate freeze" special allocations are utilized in such a limited partnership with the goal of shifting future appreciation, income and opportunities attributable thereto to the limited partners. In this scenario the C corporation receives a frozen general partnership interest with future value going to the limited partners, who may indeed be shareholders in the corporate general partner. See Freeman, *supra* at 979. More aggressive, in my opinion, are flip-flop allocations of operating income coupled with a different ratio for sharing appreciation in the underlying business assets. Freeman, *supra* at 979. Most gamy would be a combination of some, or all, of the above in a close C context in which substantially all of the limited partnership interests are acquired for a nominal amount by the shareholders of the close, but large C corporation, which after the transfer of its business for a substantially frozen general partnership interest, then elects Subchapter S status. Since the limited partnership interests are not publicly traded, the preferred approach of Treasury as to classification would not stop this gamesmanship. Rewriting the § 704(b) regulations to (a) properly reflect an aggregate approach and, hence, time value of money and assignment of income principles, and (b) remove the thumb on the scales as to ACRS deductions, no longer policy-based after PAL, would halt the most egregious abuses. The step transaction and proper aggregate approach as to § 704(b) allocations would prevent by-passing § 1374 by the former C, now S corporation. Only a deep structure revision of subchapters K and S limiting MLP's and limited partnerships in which most partners do not materially participate to an entity-conduit regime with no special allocations (and integration only through a passthrough of schedular corporate sector income) would end all gamesmanship here.

Mrs. KENNELLY. Mr. Sandler.

STATEMENT OF LEWIS H. SANDLER, GENERAL PARTNER, SOUTHWEST REALTY, LTD., AND ON BEHALF OF THE NATIONAL APARTMENT ASSOCIATION

Mr. SANDLER. I am Lewis Sandler. I appreciate your permitting me to appear today on behalf of the National Apartment Association and Southwest Realty, Ltd., a publicly traded master limited partnership engaged in real estate, primarily multifamily units in the Southwest.

Southwest Realty commenced operations and trading of its depositary receipts in February 1983. At that time we didn't know what an MLP was. We had never heard of one. Southwest Realty was created through a so-called rollup of 14 existing partnerships, each owning its own cash flowing, income-producing property in which my two partners and I were individual general partners.

There were three major considerations behind our rollup, none tax-related. The first and foremost consideration was liquidity. We have heard a lot about that, so I think I will move on and just mention that with respect to liquidity, Southwest Realty was born with the knowledge and blessing of the Treasury Department.

We had applied for and received a private ruling from the Treasury Department that our MLP would be treated for Federal income tax purposes as a partnership. The ruling was issued on the basis of certain stated facts, one of which was our tradeability and liquidity.

Without the ruling, we and others who followed us probably would not have ventured onto Wall Street.

The second most important factor behind our rollup was the ability of Southwest Realty to raise capital, additional capital, that its predecessor partnerships were unable to raise.

In fact, subsequent to completion of the rollup, we raised a substantial amount of additional equity capital through a public offering of our depositary receipts. The proceeds of the offering were used primarily to retire existing debt.

The third and perhaps the most important factor inherent in our decision to use an MLP format—was our desire to basically control our own destiny. In that regard we looked very closely at other forms of business entities that we could have chosen, including and perhaps especially REITs.

Mr. Vander Jagt earlier asked whether there were substantive differences between an MLP and a REIT for real estate entities, and I can unequivocally say yes. Some of them include: control, separate management requirements of a REIT, the requirement of a REIT to distribute a minimum amount of income, whether or not the income is passive, and the possible or potential problem of phantom income, the prohibition against reinvesting certain gains and the questions involving active and passive income, to name a few.

In addition, we have heard a number of questions raised by the panel regarding the argument that an MLP walks and talks like a duck so it must be taxed as a corporation. Contrary to what Mr.

Mentz said earlier, there are substantive differences between an MLP and a corporation.

I have discussed many of those in my submission, which I would like to be placed in the record, please.

In addition, I would like to mention two differences in particular, the first of which is the control issue, and I believe that it is more traditional in partnership format to have the general partners or general partner in control of management with very little provision to replace that management.

There are so-called democracy provisions applicable to MLP's, but they are substantively different, for the most part, from the democracy provisions applicable to corporations.

The second difference I would like to mention is that of liability. There are two parts to that liability issue. The first part is the general partner. Under partnership law you must have a responsible—a financially, economically responsible general partner to whom creditors can turn.

There is no such requirement with a corporation. If the corporation gets into trouble, you take its assets and that is it. There is no one else to look to. That is inherently not the case in an MLP or in any partnership format.

In addition, Mr. Cain mentioned that there is a certain amount of potential liability to the limited partners that you don't have in the corporation format. That liability specifically has to do with the obligation of limited partners-investors to return distributions to the partnership if the partnership improperly made a distribution and there were insufficient funds remaining with which to pay creditors.

I would like to also mention in passing that not only did we have a Treasury private ruling that said that we would be treated as a limited partnership, but I was here back in 1983 testifying before the Senate Finance Committee on the same exact issue, and at that time there was a hue and cry in the papers and in the press and a serious concern in 1983 that we were going to have a disincorporation of America, and I seem to have been defending it ever since.

It hasn't happened. Four and a half years later we still have approximately 100 master limited partnerships, hardly what I would call the disincorporation of America.

In closing, I find myself in the unfortunate position of having to disagree somewhat with one of my colleagues who spoke earlier today, and agreeing in part with Mr. Mentz. I find that a little surprising. Nonetheless, I believe, contrary to the position taken earlier by one of the panelists that we should tax all MLPs the same. If in fact we end up with a disincorporation problem or it becomes more real than apparent, there is always time to do something about it.

I don't think we should make any distinction, tax wise between any form of MLP, be it in real estate, energy or in any other business.

I would like to note that back in February 1984 in testimony before the House Ways and Means Committee at hearings on tax shelters, accounting abuses and corporate and securities reforms, there was a statement made on behalf of Mercedes-Benz by its then outside counsel, J. Roger Mentz, who was concerned about a pro-

posals to limit tax benefits on automobiles. He stated "If you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory."

If you are bound and determined to achieve a legislative solution on passthrough entities, please do it in a way that is nondiscriminatory and treat all master limited partnerships the same, and in the same manner as you treat all other partnerships.

[The statement of Mr. Sandler follows:]

TESTIMONY

of

LEWIS H. SANDLER

on behalf of the

NATIONAL APARTMENT ASSOCIATION

Mr. Chairman and
Members of the Select Committee:

Thank you for inviting me to appear before this Select Committee on behalf of the National Apartment Association and Southwest Realty, Ltd., a publicly traded ("Master") limited partnership engaged in the ownership and operation of income-producing real estate, primarily multi-family housing units in the southwest. I am personally, in my individual capacity, one of the general partners of Southwest Realty.

In addition to tax and pure economic considerations surrounding the proposal to treat certain partnerships as corporations for tax purposes, the National Apartment Association is concerned about the potentially adverse impact on the multi-family housing industry that such proposal, if enacted, would engender. Specifically, the primary source of equity capital for new construction of multi-family housing units throughout the country has traditionally been the large partnership format. Multi-family housing still requires sources of equity capital to assure a continuing source of rental housing. The proposal under consideration would eliminate one of the primary sources of readily available equity capital at affordable prices.

Southwest Realty commenced operations and trading of depository receipts representing the economic attributes of its limited partnership interests in February 1983. Southwest Realty was created through a so-called "roll-up" of 14 existing limited partnerships, each owning its own cash flowing, income-producing property in which my two partners and I were already the general partners. There were three major considerations behind our roll-up. None of them were tax-related.

The first and foremost consideration was liquidity. Prior to February 1983, we were not able to offer our limited partner investors an opportunity to sell or hypothecate their limited partnership interests. Nor were these investors able to effectively utilize their illiquid partnership investments in their estate planning. Prior to the advent of MLPs, traditional investment partnerships did not enjoy liquidity. That has changed today with the listing for trading of some (currently still fewer than 100) limited partnerships and the creation of other investment vehicles designed to acquire limited partnership interests in existing (otherwise illiquid) limited partnerships.

Our liquidity, by the way, was born with the knowledge and blessings of the Treasury Department. We applied for and received a private ruling from the Treasury Department that our MLP would be treated for federal income tax purposes as a partnership. The ruling was issued on the basis of certain facts, including the anticipated listing of our depository receipts for trading on a national exchange. Without such ruling we, and others who followed in our footsteps, would not have ventured onto Wall Street.

Today we are still a limited partnership. We are still engaged in the ownership and operation of substantially the same income producing real estate that we owned and operated in 1982 when we obtained the ruling. We are trading regularly in an orderly market. We continue to file tax returns and issue K-1's to our investors. Nothing has changed. Today, however, we hear that we would be treated for tax purposes as a corporation. I submit that such treatment is inequitable and unnecessary.

Page Two

We have deprived the government of no revenue. We do not market our depositary receipts on the basis of tax advantages. In fact to the best of our knowledge, the investing public has never paid a penny for the tax aspects of our MLP; rather, we believe that they have purchased the depositary receipts because of the yield or underlying value of the assets. This is probably true of most of the MLP's in the marketplace, although there are a few that are basically service-oriented and appear to trade on the basis of their earnings, actual or potential.

The second most important factor behind our roll-up was the ability of Southwest Realty to raise capital - additional capital that its predecessor partnerships were unable to raise. In fact, subsequent to the completion of the roll-up, we raised a substantial amount of additional capital in the form of equity through a public offering of our depositary receipts. The proceeds from this offering were used primarily to retire existing debt.

Although generally, an MLP has the ability to issue additional equity or debt, we and many of the other MLP's have found that in industries such as real estate, the ability to raise additional capital especially in the form of equity, is more readily available and the cost is more economic, than trying to raise additional debt. In the Southwest where our multi-family housing projects are located, market conditions today do not lend themselves readily to new debt issues. In fact, the newspapers are full of articles regarding the inability of existing income producing real estate to meet their current debt obligations. For some, the ability to raise additional capital in the form of equity may be the means for survival.

A third factor important to and inherent in an MLP is management's control of its own destiny. Frankly, when we were considering our roll-up, we considered and rejected the corporate format because we had no desire to go to the trouble and expense of forming an MLP only to have it taken over by corporate raiders.

Traditionally, a limited partnership structure includes no readily available mechanism for a change in management. Prospective investors of limited partnership interests are generally aware that they are buying a management team and that in the absence of malfeasance it is difficult at best, to replace that team. A review of most of the MLP's that have come to market in the last four years leads me to believe that the control issue is a dominant factor in the sponsor's determination to adopt a partnership format. That is not to say that minimum so-called "democracy" requirements are not observed. I believe that they are but at far less expense to the equity investors.

Having described Southwest Realty's individual situation, I would like to address the "corporate characteristics" issue, particularly the idea that size and tradeability are appropriate criteria for determining tax treatment. It appears that much of the interest in changing the tax treatment of publicly traded limited partnerships has been generated by a belief that these entities so closely resemble corporations that equity compels it. This resemblance is superficial, however, based almost entirely on size and public trading. These elements are not determinative criteria under current law, and I feel that they should not be under any new system of classification that Congress or Treasury might adopt.

Under the current classification regulations, known as the Kintner regulations, a partnership is defined as any unincorporated organization which carries on a trade, business, financial operations, or venture. The organization will be treated as a taxable association rather than a partnership for tax purposes if it is composed of associates who have an objective to carry on a business or financial enterprise and divide the gains and also possesses at least three of the four "corporate" characteristics: 1) continuity of life; 2) centralization of management; 3) limited liability, and 4) free transferability of interests.

Publicly traded limited partnerships have been classified as partnerships by the IRS because they do not possess more than two of the four characteristics. While it is generally conceded that publicly traded limited partnership possess centralized management, and of course their interests are freely traded, they do not possess continuity of life and

Page Three

limited liability. Those who would focus on tradeability as the determining criterion, therefore, would be greatly magnifying the importance of a characteristic which for the past twenty-seven years has--quite correctly--been only one of four equally weighted criteria.

One of the considerations before you today is whether the Kintner regulations need reworking. If that is done, I urge that you avoid the temptation to make size and tradeability the primary criteria for distinguishing partnerships from corporations.

In the first place, public trading has never been in fact a determinative or even significant characteristic of corporate status. The stock of some 98% of all corporations is not publicly traded. Furthermore, the use of public trading as a determinative factor poses real definitional problems. Markets are now developing for syndicated partnership interests. Some of these markets are exchanges; others are not. Some are regulated; others are not. Tradeability is an artificial and inappropriate criterion for deciding whether a partnership ought to be treated as a corporation for tax purposes. It is an external characteristic that has little to do with the intrinsic nature of an organization and its business activities.

In connection with the issue of tradeability, I refer you to a statement made to the Senate Finance Committee on October 24, 1983 by the then Deputy Assistant Secretary for Tax Policy, Department of the Treasury. Speaking on behalf of the Treasury Department against a proposal to treat publicly-traded limited partnerships as corporations for tax purposes, Mr. Pearlman stated "...We have serious doubt that after such an analysis, one would conclude that the degree of marketability of an organization's equity interest should determine the manner in which the organization is taxed." I concur with Treasury's position as so stated by Mr. Pearlman.

For similar reasons, the use of size as a determinant is equally inappropriate. Many syndicated, non-traded partnerships are as large as or larger than many publicly traded partnerships. Many corporations are far smaller--the majority have less than one million dollars in net worth. The number of participants in an organization or the size of its business assets is simply not a valid or relevant criterion for determining federal tax classification.

These criteria are inappropriate not only because they are inaccurate, but because they create a conflict with state partnership laws (generally the Uniform Limited Partnership Act or Revised Uniform Limited Partnership Act), which treat publicly traded limited partnerships as partnerships rather than corporations, and because they ignore several differences between publicly traded partnerships and corporations that are far more significant than size and tradeability. These differences, which tend to work to the disadvantage of partnerships, are important both to an individual's investment decision and the taxpayer's decision as to which form of business to adopt. They include:

Liability: As noted above, MLPs, like other partnerships do not offer investors completely unlimited liability. The assets of at least one general partner in an MLP must be reachable by creditors. In addition, the limited partners may also be liable to the partnership's creditors in certain cases, e.g., when there has been a distribution of capital to the partner prior to the time the liability arose. This is a significant disincentive to investors.

Perpetuity: Also as noted above, corporations are perpetual in nature, while publicly traded partnerships, like all partnership, are for a fixed term of years and may be terminated by any one of several occurrences.

Page Four

Taxation on undistributed income: Unlike corporate shareholders, partners in a publicly traded partnership are taxed on their share of partnership income whether or not cash is distributed to them. This is a disincentive to investors and, because it puts pressure on the MLP to maintain high cash distributions rather than to retain and reinvest earnings, a major disincentive for business owners.

Limits on institutional investors: Institutional investors such as tax-exempt pension funds, universities, and private foundations are a major source of capital for corporations. Various state and federal laws, however, restrict the ability of these institutions to invest in publicly traded limited partnerships.

State law: As noted above, publicly traded limited partnerships operate under state partnership law, rather than corporate law. The fact that state partnership law is less comprehensive and less settled than corporate law is another disincentive to business owners.

An entity level tax has been imposed on corporations at least partially as payment for the benefits they receive from incorporation. And ever since the income tax was first imposed, businesses have been able to make the tradeoff. They have been able to choose whether to enjoy the benefits of incorporation and pay a corporate tax in return or to forego these benefits along with the tax. I see no reason why either size or public trading should be enough to deny businesses this choice.

In short, when you examine the question of classification and pass-through entities, I urge that you resist the temptation to impose a standard that would base entity level taxation on factors such as size or public trading which have little to do with the form in which businesses have chosen to operate. I understand the appeal of these criteria; they appear on the surface to be simple and easy to apply. But one thing that I am sure you have learned in the process of tax reform is that simplicity can often work against logic and equity.

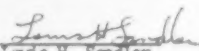
The fact that an MLP is large and publicly traded does not mean that it enjoys the benefits of incorporation and should pay for them through a corporate tax. In fact, MLPs enjoy very few of the advantages that corporations do. That is why they are still less than one percent of the capital market. To impose a corporate tax on them would not serve the cause of equity. It would, in fact, do just the opposite. As a businessman and the general partner of an MLP, I ask that you continue to allow us to choose for ourselves which benefits and burdens are the best ones for our companies to assume.

In closing I would like to leave you with a statement made in February 1984 before the House Ways and Means Committee at Hearings on Tax Shelters, Accounting Abuses and Corporate and Securities Reforms. The statement was made on behalf of Mercedes-Benz by its then outside counsel, J. Roger Mentz, who was concerned about a proposal to limit tax benefits on passenger automobiles used for business purposes to the first \$15,000 of cost. Mr. Mentz stated "To the extent that there is a personal benefit problem with automobiles, it exists for all business automobiles, not just those priced over \$15,000. ... if you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory." Continuing with Mr. Mentz's analogy, if you are bound and determined to achieve a legislative solution on pass-through entities, do it in a way that is nondiscriminatory and treat Master Limited Partnership in the same manner as you treat all partnerships.

Please leave us with our liquidity and sources of equity capital. The multi-family housing industry and Southwest Realty, Ltd. urge you to maintain the existing tax treatment for master limited partnerships. Thank you for your time and consideration.

Very truly yours,

SOUTHWEST REALTY, LTD.

By: 
Lewis H. Sandler
General Partner

Mrs. KENNELLY. Thank you.

I am going to adjourn the hearing for ten minutes and I will be back after I vote at 20 after.

[Recess.]

Mrs. KENNELLY. The hearing will continue with testimony by Mr. Rosenthal.

STATEMENT OF JEFFREY R. ROSENTHAL, MEMBER, SUBCOMMITTEE ON FEDERAL TAXATION, NATIONAL ASSOCIATION OF REALTORS, AND CHAIRMAN, TAX COMMITTEE, REAL ESTATE SECURITIES AND SYNDICATION INSTITUTION

Mr. ROSENTHAL. Thank you.

I am Jeffrey R. Rosenthal. I am a partner in the Chicago office of Peat, Marwick, Main & Co. I am testifying on behalf of the National Association of Realtors, and its affiliate, RESSI. The NAR is an umbrella organization consisting of approximately 750,000 members with interests in all types of real estate activities.

RESSI represents approximately 3,000 members who specialize in investment in income-producing real estate and mortgage loans, as well as the creation and issuance of real estate securities. Many of these real estate securities are designed to attract investment from middle-income investors, by offering relatively low-cost investment units which would not otherwise be affordable to those people.

Our primary recommendation to this subcommittee is that the tax treatment of limited partnerships as pass-through entities should be maintained, including the tax treatment of master limited partnerships, MLPs. An MLP should be defined as a limited partnership having equity securities which are both publicly offered and traded. A more explicit definition is included in my written testimony. Such securities are hereinafter called listed securities.

The tax treatment of partnerships, including MLPs, should be maintained because it is a proven capital formation technique, particularly for middle-income taxpayers. Some MLPs have been designed to appeal to wage earners with annual incomes as low as \$25,000. We feel that any limitation on capital formation, and particularly one aimed at limiting low risk, diversified investments to middle-income taxpayers, would be an undesirable effect of this subcommittee's recommendations.

In addition, the 1986 Tax Reform Act eliminated the perceived abuses which were previously associated with tax preferences, but which were not directly attributable to passthrough entities.

Consequently, entity classification rules designed to eliminate or limit passthrough entities are not warranted. The Treasury Department and the Joint Committee on Taxation have proposed to reclassify such entities as corporations, by subjecting them to either the corporate tax or the corporate minimum tax or by subjecting their investors to certain aspects of the corporate minimum tax.

Each of these proposals improperly attacks the limited partnership as the cause of tax abuse and is inappropriate because the perceived tax abuses have been eliminated and attacks on passthrough entities improperly focus on a distribution vehicle within a now neutral tax code. Therefore, reclassification proposals would

achieve little, while disrupting an important source of capital formation.

A major reason for investment in MLPs and other limited partnerships is to raise equity capital to reduce or retire debt or to acquire unleveraged real estate. This is in direct response to the anti-debt policy of the Tax Reform Act of 1986. The use of equity financing on partnership properties increases the investors' cash flows through reduced debt service.

This is also coincident with the 1986 tax reform goal of economically motivated investment decisions. In addition, debt reduction has the effect of reducing the exposure to foreclosure of many troubled financial institutions by reducing the loan to value ratios on overfinanced properties.

Thus, the elimination of a capital formation vehicle which provides additional funds to many unstable financial institutions would also be an undesirable effect of any such proposal if approved by this committee.

Although RESSI and NAR believe that the present tax treatment of MLPs and other limited partnerships is appropriate, we feel even more strongly that the current treatment of real estate MLPs and other limited partnerships predominantly investing in real estate should be retained.

Corporation taxation of real estate MLPs and other partnerships can only be characterized as a new tax increase levied on real estate, and not as an attempt to preserve the corporate revenue base, as some, including the Treasury, have claimed.

The limited partnership was the traditional investment vehicle for investment real estate before tax reform and has continued since. No significant portion of investment real estate has ever been within the corporate tax base and the idea that MLPs and other limited partnerships are removing investment real estate from the corporate tax base should be regarded as a misconception.

Treasury statistics released yesterday indicate that a significant proportion of MLPs formed in 1986 and 1987 as a result of liquidations and rollouts, the so-called disincorporation problem. Most of those rollouts relating to real estate entities involve real estate developed for sale rather than investment. In addition, last year's repeal of the *General Utilities* Doctrine now assesses tax on the removal of these assets from the corporate tax base.

Consequently, corporate classification of MLPs and other limited partnerships owning investment real estate would constitute a new tax on investment real estate, in addition to the estimated \$50 to \$60 billion that was assessed, we feel disproportionately, in the 1986 Tax Reform Act.

Finally, we oppose the Treasury's proposals for withholding at the partnership level. This proposal improperly shifts the self-compliance burden from the taxpayer to the partnership. Further, the inexact nature of such withholding would create as much administrative burden as the Treasury feels it would eliminate, due to new reporting requirements at both the partnership and partner levels.

In summary, we recommend that this subcommittee retain the tax treatment of MLPs and other limited partnerships. We stand in opposition to proposals to subject limited partnerships to the corpo-

rate tax or corporate minimum tax or to subject limited partners to certain aspects of the corporate minimum tax.

Further, we think that proposals to withhold tax at the limited partnership level are inappropriate and ineffective with respect to reducing administrative burden.

Thank you.

Mrs. KENNELLY. Thank you, Mr. Rosenthal.

[The statement of Mr. Rosenthal follows:]

Statement of Jeffrey R. Rosenthal, National Association of Realtors

My name is Jeff Rosenthal. I am a partner in the Chicago office of Peat, Marwick, Main & Co. I am testifying on behalf of the NATIONAL ASSOCIATION OF REALTORS® and the Real Estate Securities and Syndication Institute (RESSI), which is an affiliate of the REALTOR® organization. The NATIONAL ASSOCIATION OF REALTORS® is an umbrella organization consisting of 750,000 members with interests that span the breadth of real estate activities, including the ownership, operation, management, development, appraisal, and sale of single family residences and commercial real estate, including both residential and non-residential structures. RESSI represents 3,000 individuals and corporate members who specialize in investment and management of income-producing real estate and mortgage loans as well as the creation, issuance, analysis, and management of real estate securities. The group real estate investment programs in which these individuals are involved range from relatively small private placements of undeveloped land to multi-million dollar group real estate investment programs involving large real estate complexes. Many of the offerings in the post-tax reform era are designed to attract middle-income investors by offering units priced between \$1,000-\$5,000 for investment opportunities in diversified mortgage loans and/or the ownership of rental real estate.

My statement is organized and presented in the following manner. First, I shall summarize the recommendations that RESSI and the NATIONAL ASSOCIATION OF REALTORS® would like this Subcommittee and the Congress as a whole to consider in connection with its study of pass-through entities and MLPs. Secondly, I shall discuss in detail the reasons underlying our contention that the current tax treatment of both limited partnerships generally and of limited partnerships which own or make mortgage loans on rental real estate are appropriate and should be maintained. Thirdly, I shall respond to suggestions appearing in recent publications and articles arguing for the creation of a model pass-through entity to replace the partnership as an investment vehicle for real estate. And finally, I have prepared an analysis of recent suggestions that the entity classification rules should be replaced with a new standard that accentuates the importance of the limited liability test to the exclusion of other factors that are currently applied under existing Treasury regulations.

I. Summary of Recommendations to this Subcommittee:

A. The tax treatment of limited partnerships as a pass-through entity under present law should be maintained, including the tax treatment of Master Limited Partnerships (MLPs). A Master Limited Partnership or MLP is defined as a limited partnership (formed pursuant to the laws of any state) having equity securities which are registered under the Securities Act of 1933 and are either (i) traded on a national securities exchange registered under the Securities Exchange Act of 1934 or (ii) designated as national market system securities pursuant to the Securities Exchange Act of 1934 and the rules and regulations adopted thereunder. Such securities are hereinafter called "Listed Securities." Simply stated, an MLP is a partnership that has been publicly offered and has Listed Securities.

The tax treatment of partnerships, including MLPs, should be maintained as an effective capital formation technique to attract investor capital and particularly middle-income investor capital. As the ensuing discussion more clearly indicates, MLPs have been designed to appeal to wage-earners with annual incomes as low as \$25,000 by offering Listed Securities priced between \$1,000 to \$5,000. Moreover, passage of the 1986 Tax Reform Act has adequately addressed any perceived abuses that may have previously existed. Revisions to the tax rules concerning entity classification, including partnerships and MLPs, are not warranted. If Congress makes a determination, as some have suggested, that the Internal Revenue Code of 1986 should not be reopened for a period of time in order to fairly evaluate the effects of the last two Tax Reform Bills on the nation's economy, then this rationale should also apply to the present tax treatment of Master Limited Partnerships.

B. Although RESSI and the NATIONAL ASSOCIATION OF REALTORS® believe that the present tax treatment of MLPs as a partnership is appropriate, we feel very strongly that the current treatment of MLPs predominantly owning rental

real estate or making mortgage loans on rental real estate should be retained. Otherwise, decisions by the Congress to tax real estate MLPs as corporations can only be characterized as a new tax increase levied on real estate, and not as an attempt to preserve the corporate revenue base, as some have claimed. The limited partnership was the traditional investment vehicle used for the acquisition of rental real estate before the advent of tax reform and this practice has continued subsequent to the passage of that legislation. Consequently, legislation to terminate the use of MLPs owning investment real estate would constitute a new tax on investment real estate, which would be in addition to the estimated 50 to 60 billion dollars over a five year period that was assessed on investment real estate in the 1986 Tax Reform Act.

C. If the Congress acts to curb the use of MLPs, including MLPs that principally own rental real estate and/or make mortgage loans on rental real estate, any proposed restrictions should apply only to MLPs as defined above. Any proposal passed by Congress reclassifying MLPs for tax purposes should nevertheless continue to permit partnership taxation for limited partnerships which are either publicly offered or non-publicly offered and do not have Listed Securities. Any proposal to restrict MLPs that limits the use of limited partnerships that do not have Listed Securities and are formed to invest in real estate would deal a crippling blow to investment real estate, the effects of which are magnified by the impact of tax reform. A proposal to tax as a corporation a limited partnership which does not have Listed Securities and which owns real estate and/or holds mortgage loans on real estate would cause real estate limited partnerships to be uncompetitive with alternative forms of investments by drastically reducing the yield from such investments through imposition of the corporate tax. Moreover, the costs to the economy and to the real estate industry of another significant tax increase on real estate would be quite damaging in terms of higher unemployment for the construction industry, which is only now coming to grips with the adverse effects of tax reform. A new tax would also have an especially harsh effect on a capital-intensive industry, such as real estate, with a concomitantly detrimental impact on this country's GNP to which real estate contributes roughly 40% annually.

D. If the Congress decides to consolidate all pass-through entities, such as limited partnerships, RICs, REMICs, or REITs, into a model pass-through entity that would more closely resemble a REIT, as some have suggested, then many of the restrictions governing the qualification test and the asset investment rules currently applicable to REITs must be relaxed in order to provide the entity with the flexibility (which REITs currently lack and that partnerships possess) that is essential to meet the diverse needs of today's investors in a sophisticated real estate market. It should be noted that Congress recognized this need for flexibility in certain real estate investments when it adopted the REMIC as an investment vehicle for mortgage-backed securities.

II. REASONS IN SUPPORT OF RECOMMENDATIONS

A. A Proposal to Tax Real Estate MLPs as Corporations Cannot Be Justified as Necessary to Preserve the Corporate Revenue Base, But Instead Represents a New Tax on Investment Real Estate.

Because investment real estate was held in limited partnership form before the passage of the Tax Reform Act of 1986 and continues to be held primarily through limited partnerships, a proposal of a legislative or regulatory nature to classify limited partnerships with predominantly real estate interests as corporations for tax purposes would represent a new, substantial tax increase on the real estate industry. Investments in rental real estate were never a significant part of the corporate revenue base before passage of tax reform and has remained outside of the corporate revenue base after its enactment. Thus, efforts to tax real estate MLPs as corporations and not as partnerships for tax purposes cannot be justified on the grounds that such actions are necessary to preserve the corporate revenue base.

A new tax on real estate in the form of taxing real estate MLPs as corporations for tax purposes would be in addition to the estimated 50 to 60 billion dollar tax increase which the real estate industry paid for the individual and corporate rate reductions contained in the Tax Reform Act of 1986. These tax increases consist of a combination of various provisions, including: the passive loss limitation that limits the deductibility of passive losses to the income from passive activities, which is defined by

statute to include rental real estate; restrictive investment interest rules which significantly limit the deductibility of interest incurred to purchase investment assets, including real estate; reduced depreciation deductions for structures; revisions to the at risk rules; less generous tax incentives for the rehabilitation of historic structures and older buildings; and less attractive tax-exempt bond financing rules pertaining to multi-family housing, among others. The point to emphasize is that the real estate industry, and especially investment real estate, paid a disproportionate share of the tax increases contained in the Tax Reform Act of 1986 to achieve the tax rate reductions for individuals and corporations.

Although it can be argued that legislation to restrict the use of MLPs may be warranted in those instances where an active trade or business disincorporates or chooses the partnership vehicle simply to escape the corporate tax, this rationale cannot be cited as authority for taxing a limited partnership that owns investment real estate as a corporation. Group ownership of and mortgage loans on rental real estate have traditionally been made through a limited partnership and this practice remains unaffected by tax reform. Moreover, the repeal in the Tax Reform Act of 1986 of the General Utilities doctrine, which allowed tax-free corporate liquidations, now predominantly causes the costs in additional taxes of liquidating a corporation to be more expensive than the savings achieved through avoidance of double taxation. The reasons for the use of the limited partnership by the real estate industry are diverse, including both tax and non-tax factors. The major tax reason for the selection of a limited partnership as the principal investment vehicle for real estate is the flow-through nature of a partnership for tax purposes. Under the law that existed prior to the Tax Reform Act of 1986, the partnership vehicle provided partners with the ability to apply their prorata share of tax losses from the partnership investment against other income on their individual tax return and to pay only a single tax on any taxable income of the partnership. After tax reform, which repealed tax incentives for real estate, the most popular investment vehicle for rental real estate remains the partnership, due to the existence not only of only a single tax on partnership income, but also in response to the new rules imposed on real estate investments by tax reform.

In recent years, a new, larger publicly-offered, partnership having Listed Securities called the Master Limited Partnership (MLP) as defined above has been utilized to attract investment in a wide range of activities, including oil and gas, real estate, and other investments. MLPs provide the opportunity for diversification of investments to middle-income, smaller investors who have previously been denied access to the breadth of investment possibilities available to wealthier investors. MLPs are to be contrasted with other limited partnerships (including publicly offered partnerships), that do not have Listed Securities. MLPs began to be used in late 1984 and have grown in popularity in the last few years. The reasons for the surge in MLP activity vary with the nature of the industry and the type of investment involved. In the case of investment real estate, the MLP has gained prominence as a means of attracting equity capital to acquire, or construct, large residential and commercial facilities that otherwise would be beyond the reach of the middle-income investor.

A second major reason for the development of MLPs is to use the equity capital provided by investors to reduce or retire the outstanding indebtedness on existing partnership properties or to acquire unleveraged or low-leveraged real estate. Use of the MLP to acquire rental real estate with less leverage or to retire existing indebtedness on rental properties is in direct response to the anti-debt policy of the Tax Reform Act of 1986. Of particular importance is the fact that MLPs that own rental real estate do not pose a threat to the corporate revenue base. Whether or not the partnership is an MLP that represents a roll-up or a consolidation of existing rental properties or the acquisition of new properties, rental real estate was previously and currently is owned by limited partnerships in the vast majority of group investment situations.

Moreover, the use of investors' equity capital to buy new properties without leverage or with low leverage or to reduce the outstanding indebtedness on partnership properties in real estate MLPs allows the investor to obtain a higher yield by improving the cash flow of the partnership through reduced debt service. In the present investment climate, industry officials believe that a 10% to 12% annual yield is necessary to compete with alternative forms of investment and that such a return cannot be attained without significant debt reduction or retirement. Typically, real estate

investments without the tax incentives of prior law and with substantial indebtedness on the properties would have achieved an initial yield of 6%, which would make them uncompetitive with mutual funds and equity stocks in the current marketplace. Additionally, the reduction or retirement of outstanding indebtedness on rental real estate, which MLPs tend to enhance, has the salutary effect of reducing the exposure to financial institutions of troubled loans through the modification of 95% leveraged loans to 80% or less. Thus, not only does the retirement of debt on existing partnership properties through the use of MLPs serve to make real estate competitive with alternative investment choices, but these actions are also consistent with the legislative intent behind the adoption by Congress of the investment interest revisions and the passive loss limitation, which were designed to discourage debt-financed purchases of property.

A number of press reports during the past several months have attributed the growth of MLPs to the need that many investors have for large amounts of passive income to offset unused passive losses under the new passive loss limitation. While this explanation may hold true in a limited number of cases, its importance to the growth of real estate MLPs is greatly overstated. The offering materials for real estate MLPs sold during the last 12 months contain strongly worded caveats cautioning prospective investors that either Treasury regulation or legislative action may recharacterize or reclassify the income from MLPs not as passive income, but rather as investment income that cannot be offset by passive losses. The primary reason for the growth of real estate MLPs lies in the relatively high yields that they are offering investors. Current yields from real estate MLPs have frequently ranged between 10 to 12 percent, which makes them competitive with other investment choices available to today's investor. Moreover, the growth in MLPs would appear to be entirely consistent with the intent of Congress in encouraging economically-oriented transactions while eliminating tax-motivated deals through adoption of the passive loss limitation. In short, MLPs are not designed to produce tax losses, but instead are structured to generate substantial cash flow for investors.

As Congress approaches the issue of how to address the tax treatment of MLPs, the important point to reiterate is that real estate is not seeking to avoid the corporate income tax through the use of MLPs. Real estate has rarely chosen the corporate form of ownership, either before or after tax reform. While industries other than real estate may choose the MLP as a means of converting income distributions to the shareholders or bondholders from portfolio income, such as dividends and interest, into passive income by reliance on a statutory provision that deems all income from a limited partnership to be passive income (subject to Treasury regulations), this statement does not extend to real estate MLPs.

Not only have rental real estate and mortgage loans on rental real estate traditionally operated in partnership form, but the statute specifically defines rental real estate to be a passive activity that generates passive income, irrespective of whether the property is held by a sole proprietor, an investor, or partnership. Accordingly, the creation of real estate MLPs to produce cash flow characterized as passive income is not a subversion of the statutory intent behind the passive loss provision, which was to treat rental income as passive regardless of the form in which the property is owned. The use of a limited partnership or MLP to invest in rental real estate should not alter that result, when any trade or business income from a limited partnership is generally treated as passive income by statute.

Finally, there have been comments appearing in recent tax publications alluding to the administrative problems arising from the operation of an MLP. As a member of Peat, Marwick, Main & Co., with practical, ongoing experience in the area of limited partnerships and MLPs, I believe that the problems of administration attributed to MLPs are exaggerated. Most Big Eight Accounting firms have developed programs and internal systems that adequately address the recordkeeping concerns and compliance problems of administering an MLP. Moreover, the nominee reporting rules contained in the 1986 Tax Reform Act address many of the concerns regarding tax compliance and administration of MLPs. In short, Congress should not take action restricting MLPs in an effort to combat a problem that has already been reduced to manageable proportions.

B. Although RESSI and the National Association of Realtors firmly believe that the present law tax treatment of MLPs should be maintained, we feel even more strongly that any proposal adopted by Congress should not apply to

limited partnerships that do not have Listed Securities. The reasons for this position are listed below:

First, if the Congress decides to tax MLPs as corporations because the interests of MLPs are Listed Securities, this rationale does not apply to interests in limited partnerships that do not have Listed Securities. Interests in limited partnerships that do not have Listed Securities are not liquid and are subject to numerous restrictions on their transferability. In 1986, for example, less than one percent of the units in public or non-public limited partnerships, which do not have Listed Securities, were sold for value. In many cases, a limited partner who wishes to sell his interest in a partnership must obtain the consent of and grant the right of first refusal to the general partner. Moreover, often a transferee must meet an original investor's suitability requirements and/or obtain regulatory approval. In short, an investment in a publicly-registered limited partnership contrasts sharply with an interest in an MLP based on the liquidity or lack thereof of the investment.

Secondly, imposition of a corporate tax on publicly-registered limited partnerships would reduce the yield from investments to such a degree that use of the partnership as an investment vehicle would be inappropriate in most instances. Yet, the limited partnership is the only investment vehicle currently available under our present tax system with sufficient flexibility to attract investor capital, especially middle income investors, in the post-tax reform era. A recent article in the Wall Street Journal (June 11, 1987) correctly observed that public partnerships are presently being offered in small denominations, such as \$1,000, in order to attract middle income investor capital to the market. Many investors have annual incomes as low as \$25,000. The article further points out that the real estate acquisitions being made by such partnerships are of a low-risk, low-leveraged variety, because middle-income investors cannot afford to take undue risks. Once again, the growth of real estate limited partnerships that offer the small investor the opportunity to obtain a high yield from an investment realizes the goal of Congress in the 1986 Tax Reform Act to encourage economically-sound transactions. Furthermore, such partnerships offer the investor the ability to invest in major projects, such as apartments, shopping centers, hotels, commercial office buildings, resort communities, and other real estate investments of a magnitude that would be unavailable to the investor without group investment. In addition, the article observed that non-public, private placement offerings which are generally offered to wealthy investors in real estate have declined precipitously since passage of the tax reform bill. Private placement offerings tended to be those that provided investors with substantial tax benefits which are no longer available after tax reform. Specifically, The Stanger Report projects total private partnerships sales of roughly \$1.5 billion for all of 1987, which is a substantial decline from the \$3.5 billion in private placement capital raised in 1986.

C. The Partnership is the Sole Investment Vehicle with the Flexibility to Meet the Diverse Needs of Real Estate Investors, Developers, Lenders, and Borrowers.

Flexibility has always been the hallmark of the partnership as an investment vehicle that distinguished it from other forms of investment. The partnership as an investment vehicle provides optimal flexibility to meet the diverse needs of a wide range of investors in a sophisticated real estate market. To illustrate, in a typical real estate transaction, a priority distribution of a specified amount can be provided to a person or entity contributing substantial capital to the development of a real estate project, while another investor can receive a higher percentage of cash flow remaining in excess of the priority distribution. A permanent lender may receive a percentage of the economic appreciation on the sale of the property. The general partner may receive a percentage of the economic appreciation on the sale of the project subordinated to a specified return to investors and may also receive a different percentage of the cash flow during the operation of the property. These allocations are also important for economic, non-tax reasons, because they provide a means for incentive compensation to developers and others active in the real estate business. This degree of flexibility is unattainable with any other alternative form of investment vehicle.

What this example illustrates is that neither a corporation nor a REIT can vary the percentage of ownership for each equity owner in different items of income, loss, gain, and cash distributions while a partnership possesses the

ability to alter allocations of income, loss, gain, and cash distributions, to meet the needs of various participants to a real estate transaction. While special allocations of income and loss have tax ramifications that produce different tax results for various partners to a partnership transaction, the recently finalized regulations under Section 704(b) mandate that such allocations must have substantial economic effect if they are to be recognized for tax purposes. Consequently, the potential for abuse of the tax laws under the special allocation provisions of the Federal income tax laws are negated to a large degree. The important point to emphasize is that special allocations are utilized in a partnership agreement, especially in the post-tax reform era, primarily to meet the business needs of the parties and not to achieve tax objectives.

D. Imposition of a corporate tax on real estate limited partnerships that do not have Listed Securities would discourage group investment in rental real estate by drastically reducing the yield from such investments.

Information furnished by the industry indicates that partnerships specializing in real estate have prospered during 1987, because the real estate industry responded to the impact of tax reform by structuring transactions to meet the needs of today's investors. Real estate limited partnerships are raising equity capital from investors to acquire additional properties or to retire or reduce existing debt. Thus, real estate offerings have moved away from the traditional use of leveraging and high debt financing to a market in which equity capital or low leverage furnishes much of the resources necessary to finance the development or acquisition of rental properties. Moreover, continuing the trend that began after passage of the 1984 tax bill, the real estate industry has offered the investor, through use of the real estate limited partnership, a viable entity that provides the potential for significant cash flow and economic appreciation by reducing the debt service on existing properties and financing the purchase and construction of new properties. By the attraction of investor equity or low leveraged capital, as well as through a reduction of various fees charged by the promoter and syndicator, the real estate industry has been able in recent years to provide more attractive yields to investors on rental real estate investments, which make real estate competitive in the marketplace with alternative choices.

However, imposition of a corporate tax on the cash flow of a real estate investment from a limited partnership that does not have Listed Securities would reduce the yield from the investment to such a degree that a real estate investment would no longer be competitive with other investment possibilities. This is especially true for retirement plans which represent a growing segment of the real estate investment market. Statistically, the share of equity capital provided by retirement plans, especially small retirement plans, has risen at an increasing rate over the last several years. Because such plans, such as pension funds, are tax-exempt entities, investments by pension managers are made on the basis of annual yield and economic appreciation and not because of tax incentives. In 1986, more than 60% of the \$9.4 billion raised in equity capital through public offerings of real estate limited partnerships, was funded by retirement plans, whereas the percentage of equity capital furnished by such plans in 1982 was only 50%.

An even more positive development for the real estate investment market in recent years has been the tendency of retirement plans, especially the smaller plans, to diversify their investment portfolios by placing a higher percentage of their assets in real estate. Previously, asset managers for retirement plans generally followed a conservative investment policy that directed plan assets primarily into stocks and bonds. ERISA encourages retirement plans to diversify their assets, which should appropriately include investments in real estate. The group real estate investment industry has created limited partnership investment opportunities to enable retirement plans to invest in real estate. Recent studies have shown that a more diversified investment plan for retirement plans, including a higher percentage of investment in real estate assets, would have produced a significantly higher yield for retirement beneficiaries than their actual investment decisions produced. For example, during the eleven year period from 1972 through 1982, the financial return for real estate investments was 11% in comparison to 7.7% for common stocks. The yield to retirees and pension beneficiaries would have increased to 8.3% from 7.7% if the institutional managers of pension funds had invested 20% of their assets in real estate and only 80% in common stock as opposed to the actual percentage of only 3% or less invested in real estate during that same period.

However, the current trend for retirement plans, especially smaller plans, to invest more resources in limited partnerships that do not have Listed Securities would quickly be reversed if a corporate tax is levied on the income of such partnerships. If that eventuality were to occur, payment of the corporate tax would consume too much of the cash flow from the real estate investments made through the partnership to allow such investments to be competitive with alternative choices available to individual retirement accounts or pension managers for retirement plans, whose primary responsibility is to achieve a yield sufficient to meet the retirement income needs of their beneficiaries. In fact, many pension managers would eschew investments in real estate limited partnerships that were reclassified as corporations for tax purposes simply because the corporate tax was imposed, irrespective of the economics of the transaction or the amount of the tax. Thus, the movement by pension managers towards diversification of the investment portfolio would be brought to a screeching halt, which would be to the detriment of the overall yield attained by retirement income beneficiaries and to the further dismay of the real estate industry. Moreover, not only would the yield from real estate investments made by limited partnerships be drastically lowered by reason of the imposition of a corporate tax, but the economic appreciation of interests in real estate limited partnerships that do not have Listed Securities would be reduced by reason of the lower income stream available to investors.

E. If the Congress decides to adopt a model pass-through entity for all types of investments, in lieu of all existing pass-through entities, including the limited partnership, then the model pass-through entity must contain the flexibility which partnerships possess under current law.

During its consideration of the proper tax treatment to be accorded pass-through entities under the federal income tax system, if the Congress decides to consolidate all pass-through entities, including limited partnerships, RICs, REITs, and REMICs, into a single, model pass-through entity that more closely resembles a REIT than any other flow-through vehicle, then we would recommend that such an entity be granted the flexibility which the partnership possesses and which the other investment vehicles, the REIT, the corporation, and the S corporation, lack.

Under present law, a partnership agreement can be drafted with the flexibility necessary to meet the individual needs of particular partners. The flexibility to adopt these features is not present under existing law in either a REIT, a RIC, a REMIC, an S corporation, or an ordinary corporation. In order to make the REIT a more attractive vehicle for real estate investment, substantial revisions are required to the rules governing both the qualification of REITs and the investment of REIT assets in addition to the changes made to the REIT rules in the 1986 Tax Reform Act. If additional changes are made to the REIT provisions allowing for this flexibility, then such a hypothetical REIT would approximate the tax treatment of limited partnerships after tax reform, which limits the deductions from passive activities to the income from such investments. Certainly, one change that should be immediately adopted is to treat the income distributed by a REIT as passive income instead of as portfolio income which is presently the case. This revision would merely conform the character of income from a REIT to that of income from a limited partnership owning rental real estate. However, if these changes are not made, then the REIT as an investment vehicle is too inflexible to attract anything but a small percentage of the total investment capital currently invested in rental real estate. In the absence of a viable investment vehicle to meet the needs of today's real estate investor, the implications for the real estate industry would be ominous.

Even more significant revisions would be required to cause the corporation to be an attractive investment vehicle for rental real estate. Apart from the adverse feature of double taxation, the corporation can only offer common or preferred stock to its shareholders or debentures to its lenders. A corporation does not possess the flexibility to provide different shareholders with varying percentages in different layers of income and loss associated with corporate assets. If the S Corporation is chosen to be a candidate for a model pass-through entity, then its rules must also be substantially revised. These revisions would be in addition to the changes made in the 1982 legislation regarding S Corporations. Current rules allowing S corporation status only where a corporation has 35 or fewer shareholders must be relaxed. Additional revisions that would be required to make S Corporations a suitable vehicle for real estate investment include revisions to the basis rules governing the basis that a shareholder in an S Corporation has in his stock

and the rules must also be overhauled regarding the percentage of passive income that an S Corporation can have without disqualification. A further drawback to the use of an S corporation as an alternative to a limited partnership for real estate investment is the fact that many states, including California, do not recognize the existence of an S corporation under their state income tax laws. In those states, the effect is that the income of the S corporation is subject to the state corporate income tax, which substantially reduces the yield in those states.

F. Comments on Suggested Revisions to the Entity Classification Rules

Recently, there have been a number of proposals to revise the rules governing the appropriate classification of an entity, including a limited partnership, under the Federal Income tax laws.

Under Treasury Regulations, (Section 301.7701-3), partnerships are distinguished from corporations by determining whether four corporate characteristics apply to the entity in question. These corporate characteristics are continuity of life, centralized management, limited liability, and free transferability of interests. Under these rules, an entity is taxed as a partnership for tax purposes if it possesses no more than two of these attributes absent other factors indicating corporate classification. If an entity possesses more than two of these characteristics, it is taxed as a corporation.

In one such article, it was suggested that the entity classification rules be revised to include only one criterion, which would require an entity to pass a vastly expanded test of unlimited liability in order to warrant classification as a partnership for tax purposes. These suggested revisions to the characteristic of limited liability would cause an entity to be taxed as a corporation, whether or not the business was conducted in partnership form, if either the partnership did not have general partners with a net worth (excluding the value of partnership property) at least equal to the outstanding liabilities of the partnership or if less than a substantial amount of the partnership liabilities are not on a recourse basis for which a partner(s) has personal liability. If both tests are met, the entity would be taxed as a partnership, but only the general partners with exposure to liability would be allocated the tax losses of the partnership.

This approach, if implemented, would cause serious disruption to investment real estate and would raise more questions than it answers.

First, if the general partner must have a net worth at least equal to the amount of partnership liabilities without taking into account the value of the underlying collateral, then virtually no real estate partnership would be taxed as a partnership. Few, if any, general partners in real estate developments have sufficient net worth to equal the amount of outstanding partnership debt without regard to the value of partnership property. Moreover, it is inequitable to assume that the partnership assets have no value in determining whether one or more partners have a net worth adequate to cover partnership debt. In addition, if the net worth of one or more partners must equal the amount of debt incurred by a partnership owning rental real estate in order for the partnership to avoid the corporate tax, then why should such a test be applied only to partnerships? Would such a test also require individual owners to have a net worth equal to the amount of debt on the rental property to avoid corporate taxation without including the value of the property?

Secondly, even if one or more general partners has a net worth equal to partnership liabilities excluding the value of partnership property, the proposed test would tax the partnership as a corporation if more than an insubstantial amount of the partnership debt were nonrecourse in nature. Such an approach would cause a drastic overhaul of the prevailing use by lenders of nonrecourse financing on both residential and nonresidential rental properties. In the typical situation, a construction loan for the development of rental real estate will be a recourse loan for the simple reason that collateral does not exist to reassure lenders until construction is completed. When the structure is placed in service, the permanent lender provides a nonrecourse loan to take out the construction lender and secure repayment of the loan with the property. It should be noted that lenders who arrange nonrecourse loans do not do so to further the tax objectives of the borrower, but because they have collateral in the structure that equals or exceeds the outstanding debt owed them by the borrower. Moreover, many

states, including California, mandate the use of nonrecourse financing in a number of real estate transactions. Furthermore, the question must be asked, if the presence of a significant amount of nonrecourse indebtedness on partnership property causes the partnership to be taxed as a corporation, why should this test not also be applied to individual owners of rental property, causing them to be subject to the corporate tax, if their property is financed with a nonrecourse loan.

And finally, the proposal would require partnership tax losses to be allocated exclusively to those partners with unlimited liability even if the net worth and recourse liability tests were met. This aspect of the proposal would require a substantial rewriting of the special allocation provisions of Section 704(b) of present law. Treasury regulations, which were recently finalized under Section 704(b), require substantial economic effort in order for allocations of income and loss that are contrary to the general profit and loss ratio to be respected for tax purposes. Most tax experts believe that the final regulations address the potential abuses of noneconomic, tax-motivated allocations under prior law. Also, the proposal only suggests that tax losses be allocated to partners bearing the risk of loss, but does not discuss the allocation of income. Would income follow loss allocations for tax purposes or would it be allocated under a different formula? Moreover, such a proposal would be contrary to the widely accepted view reflected in the 704(b) regulations that those investors who may lose capital in a transaction should be entitled to a deductible loss from their economic investments.

CONCLUSION

To summarize, both RESSI and the NATIONAL ASSOCIATION OF REALTORS® strongly believe that the present entity classification rules should not be changed and that the current tax treatment of partnerships, including MLPs, should be maintained. The Tax Reform Act of 1986, which repealed or greatly curtailed tax incentives for real estate investment, has adequately addressed any perceived tax abuses. Revisions to the entity classification rules are unnecessary and would be a case of overkill at a time when the real estate industry is adapting to the effects of tax reform.

If Congress is of a different view, we urge you to target the perceived abuses only and not to adopt a sweeping proposal that could have devastating effects on the real estate industry, which already is in a period of transition after tax reform. RESSI and the NATIONAL ASSOCIATION OF REALTORS® stand ready to work with the tax-writing Committees of Congress in drafting appropriate legislation, or to answer any questions that you may have.

Mrs. KENNELLY. Mr. Lee, you mentioned that material participation is an important criteria that this committee should address. Do you think that is more important than whether the business conducted by the organization is an active business that traditionally has been a corporation?

Mr. LEE. I think those are two different questions. First is in terms of an entity versus aggregate approach, material participation is the question. In terms of now we have something that the people don't materially participate in and therefore it has to be an entity, at that point when we determine whether we can have a passthrough and, if we do, what level of taxation is carried, only the active business/passive investor should be carrying this corporate sector tax I have been talking about.

If it is passive business/passive investor, then it should be a separate entity, but should probably be able to pass through at the regular individual rates, much like an S corporation is what it would look like.

But if the enterprise is active business/passive investor, then in 1986 you decided that it carry, say \$220 billion; and we can't let that type of active business/passive investors go into a different plastic wrapping and not carry that burden.

So it is both.

Mrs. KENNELLY. Would you agree, Mr. Wilson?

Mr. WILSON. My comment revolves around the inequity of taxing a partnership because you bring in public unit holders and it is patently unfair, just because in our case we have sold some of our units to individual unit holders, that the whole partnership should be taxed.

However, I think that there is a position—this morning there was some question raised by someone—I can't remember who it was, one of the Congressmen—concerning how to get around this question.

I would think that the following would probably be a solution, while it is not an acceptable solution to everyone—I would think that a partnership should not be taxed as a corporation just because it has a public shareholder, but when it decides to make a decision to sell shares to the public, when it makes that threshold decision, they have to consider that the distributions are going to be portfolio distributions as opposed to the possibility of them being considered otherwise.

Now, the Treasury has this power now—this Congress gave the Treasury that kind of power and, in my opinion, that might be a place where it can be applied, in other words, to warn all the people in the industry, when you decide to sell public units of a partnership, you are automatically going to be considered to be portfolio income.

When that is known, then that decision will be made and taken into account before they go public.

But I just believe that what we are considering now is wrong. I will liken it to this. Loopholes for taxing are just as bad as loopholes for not taxing. What is being considered right now is creating a loophole for taxing a particular entity because a public unit holder has bought a share of the unit. It just defies logic as to why that is equitable, why it is fair.

However, another alternative is once the enterprise is public, its distribution is then portfolio income. I think there might be merits to that. I personally think that there is a lot more merit to that than what we are considering right now.

Mrs. KENNELLY. Maybe I could ask Mr. Sandler or Mr. Wilson to comment on another suggestion by Professor Lee that single tax treatment should only be allowed to organizations in which investors materially participate in a venture.

I think you suggested, Mr. Lee——

Mr. LEE. What I said——

Mrs. KENNELLY [continuing]. That a single tax treatment should only be allowed to organizations in which investors materially participate.

Mr. LEE. What I said was aggregate, which means you are treating the partner or the shareholder as if they own the underlying property and automatically pass it through. That should only apply when you materially participate.

If you do not materially participate, there could be a single tax. But the framework would be like Secretary Mentz suggested a year ago, that all S's and K's be taxed, all subchapter S's and partnerships, be taxed much like subchapter S's.

That would be Treasury's model that would be available if you did materially participate. You would be more like an S corporation, even if you were a partnership.

The next question becomes: Do we, if you are a separate entity, allow you to pass through, and that would be under \$100,000, sure, no problem. Over \$100,000 we begin to get into the corporate sector area and, if you are going to allow them to pass through, it could be a single tax but not a single tax at 28 percent, the individual rate, on an eroded corporate tax base. It would have to be 28 percent on economic income or, say, 45 percent on the eroded base.

Mrs. KENNELLY. I was going to ask Mr. Sandler and Mr. Wilson, aren't we complicating this to such an extent that we have done away with people making the decision anyway?

Mr. SANDLER. I think that the distinction—we are trying to make a distinction between who are the active or passive investors in a partnership format. Academically it may be sound, but I think as a practical matter it would be very difficult to determine.

I have been a general partner in small partnerships where we had ten investors. I am now individually a general partner in a master limited partnership where we have thousands of investors.

The little old man or little old lady who has her 100,000 shares or depositary receipts in Southwest Realty takes a very active interest in the management of our business and doesn't hesitate to call and tell us what to do. To the contrary, the large investor, when I had a partnership in which we had ten large, very sophisticated investors, tended not to take an active role.

So although it sounds good, I don't know how you would make that determination—certainly not on size, because I think that is artificial, just as I think it is artificial as to what kind of business the entity is engaged in. You should treat all partnerships the same, whether they are in one kind of business or the other, all partnerships the same regardless of the number of people in them.

Mrs. KENNELLY. You agree with Mr. Wilson on that?

Mr. SANDLER. Yes.

Mrs. KENNELLY. Mr. Wilson?

Mr. WILSON. I would like to point out something. We are in the home-building, land development, building of apartments and so forth. Somebody this morning raised the question about a level playing field.

Mrs. KENNELLY. They always do.

Mr. WILSON. I would like to point out that in our industry the majority of home builders pay taxes at one level. That may come as news to this committee, but generally speaking home builders are two or three individuals owning a corporation.

I have built homes for 30 years. I would be out of my mind to do it any other way. So we are building homes in subchapter S corporations. Too, we are building them in partnerships that are closely held and closely controlled, one level of tax. The public companies that we compete with, they represent maybe 10 or 15 percent of the total home building capacity of the country.

So, in effect, 80 to 85 percent of the revenue derived from home building is probably singly taxed. Now we are a partnership that is involved in that business, and I see no reason why we should inherently be classified with a couple of public corporations that are clearly paying corporate tax and require because they are paying corporate tax because of home building, that we as a partnership should pay, whereas the partnership I am competing against, which is closely held, is not.

In other words, there is not now a uniform playing field and there never was.

The question now becomes: Why tax this partnership because it has a couple of public holders? That is bad tax policy, in my opinion, and I am saying, in effect, that the threshold should not be whether the public shareholders are involved or not, it should be just a general presumption that when you become a public partnership, at that point in time the income becomes portfolio income, and that solves that problem. And those partnerships that want to become public also know that is the threshold question.

In our case we would not have done it, but in the future those who are going to do it, they will know that is one of the decisions to be considered.

I just think it is bad policy at this point to put us in a position of having issues shares to public unit holders after 2 years of hearings and that we are going to put them in a position where they are going to lose part of their investment.

The stock is dropping just because of the public disclosure of this hearing. If there is a move to pass this kind of what I call discriminatory legislation, it is going to drop the value significantly more.

The only one that got hurt is the public. I am not going to get hurt because we will become a private partnership the day after the law is effective. As far as the revenue the Treasury will get, put a line through it. We won't be there.

Mrs. KENNELLY. Partnership level withholding to ensure compliance, is there some way that we can calm the worries of Treasury that we are going to have this hemorrhaging—is there something we can do now?

You have a success story. What could we look at to do to get some revenue—we have compliance.

Mr. WILSON. With due respect to your intent, and I appreciate what you are saying, it has been my experience that the agencies of Government charged with the responsibility of carrying out the congressional intent are always looking for some easy way to do their job.

It seems to me right now that they have a problem of collecting taxes from stockholders who have stock in street names, who have them in corporations, who have them hidden away.

They have the problem of trying to track a dividend from those sources and they have been working on it for a number of years by having the reporting system on dividends and so forth.

It so happens that because of the focus of Treasury on partnerships, we are under the microscope, and I would suggest right now that if anything is true, we probably have more of an attempt to control that phantom that the Treasury raises than any single industry. In other words, the partnerships are probably going to do a better job of seeing to it that the taxes are paid by its unit holders than stockholders in corporations.

Now, if that does not work, after thirty years of appearing before congressional committees, the one thing I know for sure is these issues never die. If it does not work, I am sure we will be back in 24 months saying let's have a change, and I would be testifying we didn't do the job, let's change it, have withholding.

But I would think right now, having just put in a new law on January 1 and having a hearing today without having a chance to see if that which we did January 1 is working is really the wrong way to go about solving this problem.

I don't think that we ought to discriminate against a partnership unit holder as opposed to a stockholder in any other corporation at this point until we are sure that there is, in fact, a problem.

Mrs. KENNELLY. I heard almost immediately after we finished tax reform for 1986, the buzz—if you have been around the Hill, you know how quick the word goes. Immediately I heard that this passive loss limit is fine and good. If you form a partnership you can get around it and it won't hurt the real estate industry, they in fact can adjust. How do you answer that, because I think that is why you have developed so quickly.

Mr. WILSON. I live in Middleburg and I operate out of Washington and I agree with you, as soon as you leave this room there will be some discussion on how to get around whatever it is you raise. That is the American system of business. Thank God for it. That is what keeps us on top, and I would have to say there is nothing wrong with that until it is abused, and when it is abused I know the Congress knows how to take action on that, such as you did in the real estate industry.

I supported the changes in the real estate because there was massive abuse. I am not one that says that you start taking action on a perceived threat before you know the threat to be real. The problem we have right now is that everybody is right but at different times.

The Treasury was absolutely right last year. There is no doubt that we were going to reorganize America's business into partner-

ships, had the Congress, your committee, not taken effective action on two very important points. Those points were the *General Utilities* doctrine, which clearly it makes no sense for a corporation to pay a liquidation tax, pay another tax at the stockholder level in order to put into a partnership.

As a matter of fact, I proposed the following theory: In some respects, if you want to balance your budget, reverse that and you probably will balance the budget in the next 2 years because clearly it will be a massive conversion, there is no doubt. But you did take care of that.

Unfortunately the conversations I hear are by people who listened to it last summer, not realizing that the two major changes that you made effectively will prevent it.

As you know, there is always someone who doesn't get the word. Having attended the hearings last year, there are an awful lot of people who have massive conversion in their mind. They think that the MLP income is a tremendous tax source. It is not. And they don't realize it because they don't have the facts.

As a matter of fact, the Treasury doesn't have the facts. They are proposing it and they don't even have the facts. Very interesting. They are saying there is a lot of money to be had on doing this but they don't really know for sure, and when they put it together, a good portion of that income that they are talking about is the classification of portfolio versus passive, and I am saying to you in advance that if that issue is resolved for the public partnerships, and distributions is automatically classified portfolio income, then the Treasury's numbers drop from \$600 million down to maybe \$100 or \$50 or maybe nothing—a very interesting proposition, and they have the tools to do that.

Mrs. KENNELLY. Who has the tools to do that?

Mr. WILSON. The Treasury has the tools to do that. You gave them broad authority, almost gave them carte blanche on qualifying partnership income as portfolio income and not just public, but even private partnerships, which is the proper way to go.

Mrs. KENNELLY. Thank you.

I have been dying to hear the answer to that question myself, and I appreciate it.

Mr. Sandler?

Mr. SANDLER. I was just about to take some issue on whether Congress' authority was quite that broad.

I think that is somewhat debatable as to whether Treasury can simply classify whatever it wants to as portfolio income. The issue of whether it should be portfolio income or not is really not before us now, although if that comes before us I am sure we would have a lot to say about it.

Mr. ROSENTHAL. With respect to the questions you have asked, the first had to do with whether or not material participation should be a factor in determining at one level or another of Professor Lee's comments, whether or not you should have an entity taxed as an entity or as a passthrough entity.

I think that there are a number of problems with that. First of all, defining material participation was something that you and the Congress had an awfully hard time with just last year. I could ask any of the members of your committee, any of the members of the

Senate Finance Committee, to define that and I am not sure that they could—

Mrs. KENNELLY. I am sure Mr. Dorgan could.

Mr. ROSENTHAL. Maybe he could. I will bet I could disagree with him. I don't think that that is a standard that would work.

Further, the definition of "participation" in each and every industry is different. It is not a workable solution, and for that reason I can't see the link to how you decide whether you tax an entity or whether you don't.

With respect to your question on withholding, I am opposed to that because I don't think it achieves the purpose that it is alleged to achieve, getting more compliance. There are a number of issues relative to compliance, one of which that is clearly important is the complexity involved with compliance.

There are a lot of problems with taxpayer compliance in this country, simply because they don't know what to do with the information that they have. A lot of people think that compliance is just the so-called underground economy where no tax is paid.

There is a problem where taxpayers just cannot process their own tax returns. Adding withholding to a partnership K-1, which is admittedly complicated, would not achieve any more purpose than the problems that it would create. You would have taxpayers deducting the taxes thinking that it is a dividend, some type of deduction that is passed through to them, others picking it up as income because they think it is equivalent to a dividend.

Consequently, I don't think that the withholding would do a particular amount of good.

Mrs. KENNELLY. Thank you.

Thank you all for excellent testimony and thank you very much for coming.

The hearing is adjourned.

[Whereupon, at 1:50 p.m. the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT
ON
MASTER LIMITED PARTNERSHIPS
for submission to the
SUBCOMMITTEE ON SELECT REVENUES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for
ARTHUR ANDERSEN & CO.
By
Richard A. Gordon*
June 30, 1987

OVERVIEW

In response to congressional interest in the current-law tax treatment of master limited partnerships (MLPs), Arthur Andersen & Co. has prepared an analysis of the key issues that should be considered in the course of the debate. A report, based on that study, has been prepared and is submitted as an exhibit to this statement. The study does not attempt to evaluate whether the existing regulations distinguishing between corporations and partnerships are appropriate or satisfactory. Indeed, that issue does not appear to be the focal point of the public debate. Rather, this report considers whether the formation of MLPs threatens to erode Federal tax revenues and whether MLPs can be justified as a proper form of business organization.

Those concerned about revenue loss, inevitably assume that more tax revenue would be collected from a two-tiered system of taxation than from a single level of tax. Viewing MLPs as corporations in disguise, they contend that significant revenues could be raised by taxing MLPs "like corporations" and imposing tax both on the MLP and its investors.

Our conclusion is that this concern over an MLP-induced threat to Federal revenues is greatly exaggerated. Based on an analysis of MLP operations and on a systematic review of the dual level of taxation at the corporate and shareholder levels, it appears that MLPs do not cause a substantial erosion in the Federal tax base. In fact, depending on how much tax revenue is collected on the transfer of appreciated property, tax revenue may actually be enhanced by the formation of MLPs. Thus, on a tax-revenue basis, the report concludes that a change in the present-law tax treatment of MLPs is neither necessary nor appropriate.

An MLP, like any other partnership, is organized and governed by state law. The main distinction between an MLP and any other limited partnership is that MLP units are traded on an established exchange. This facilitates the movement of capital in the economy and benefits both MLP sponsors and potential investors. Notwithstanding dire claims of a "proliferation" of MLPs, as of March 31, 1987, only 83 had been formed since 1981. While most MLPs were formed in the economically-depressed oil and gas and natural resources industries, many recent MLPs have been formed in the real estate, construction, and investment industries. As of March 31, 1987, MLPs had an aggregate market value of \$31.2 billion, with nearly 70 percent of that value still held by the original corporate sponsors.

Some have expressed the concern that the Tax Reform Act of 1986, by lowering the top individual rate below the top corporate rate, has created a further incentive for corporations to convert to MLPs. In fact, while under the old law the potential net return to an investor was as much as 85 percent better in a partnership than in a corporation, under the new law the potential benefit to an investor has been reduced to 52 percent. This reduction in the potential advantage that a partnership has over a corporation can hardly be the cause of a stampede to form MLPs.

*Partner, Office of Federal Tax Services
Arthur Andersen & Co.

- 2 -

Of the various concerns expressed by MLP opponents, the threat to Federal tax revenues has probably received the most attention. In a two-tier corporate-shareholder system of taxation, corporate earnings are taxed at the corporate level and are taxed again when distributed to shareholders. An MLP, in contrast, is not taxed at the entity level, but its unit holders are taxed currently on their share of the MLP's income. This difference in treatment, however, does not mean that substantial revenue could be raised by applying an entity-level tax to an MLP as if it were a corporation. There are a number of reasons for this conclusion.

- o MLPs are not suitable for all sectors of the economy or for all types of business. Thus, an explosion of MLP formations is unlikely.
- o Notwithstanding separate corporate and shareholder taxes, not all corporate income is taxed twice. About 50 percent of corporate earnings are retained for reinvestment and, thus, are not taxed currently as dividends at the shareholder level. Moreover, some corporate income is paid out as deductible interest expense and, thus, is not even taxable at the corporate level.
- o Not all corporate income that is paid out is taxed to the recipient. Tax-exempt institutions, such as pension funds, are significant holders of corporate stocks and bonds. These entities do not pay tax on their receipt of dividends or interest.

Since not all corporate income is taxed at both the corporation and shareholder levels, it is highly unlikely that all MLP income would be taxed twice if MLPs were taxed as corporations. Thus, the revenue potential from a change in the law would seem minimal at best.

The notion that the formation of an MLP by a non-liquidating corporation constitutes "disincorporation" is simply wrong. A corporation that forms an MLP from its existing operations, does not remove productive assets from the corporate-tax system. It retains the value of those assets either in the form of MLP units, or it receives the economic equivalent in the form of sales proceeds. In either case, the same potential for producing income continues to reside within the corporation.

Rather than being a device to avoid the corporate-income tax, MLPs play a positive role in the U.S. economy. Consistent with the theme of economic efficiency trumpeted by supporters of the Tax Reform Act, MLPs can be viewed as a form of business organization that is good for the economy, one that increases national output by improving the allocation and use of economic resources. In particular, MLPs have four desirable characteristics:

- o MLPs provide an incentive to distribute cash to investors that might otherwise be invested in a less economical fashion;
- o MLPs channel investment funds to their most productive use, they facilitate growth and productivity, and provide unit holders with a more secure and certain return on their investment.
- o MLPs provide the MLP-intensive sectors of the economy with a source of capital comparable to that which the corporate sector acquires through internal finance or access to pension funds and other tax-exempt entities; and
- o MLPs improve liquidity and reduce the risk of bankruptcy in an activity by curtailing the level of debt.

Evidence from the oil and gas and real estate industries demonstrates that assets may be valued more highly when held by an MLP than by a corporation. The basis for this premium valuation is that, because of a favorable distribution policy, MLPs give investors greater confidence that they will actually receive the cash flow generated by their investment. The increase in asset value associated with the formation of an MLP enhances the ability of the corporate sponsor to raise capital in an efficient manner, facilitates the acquisition of other property, and protects the corporate sponsor from an unfriendly takeover challenge by ensuring that its stock reflects full market value.

- 3 -

In addition to a revenue concern, those who propose changing the current tax treatment of MLPs contend that MLPs have an unfair competitive advantage over those businesses operating as corporations. Perhaps equating size and tradeability with corporate similarity, this view overlooks the fact that MLPs are legally, functionally, and economically different from corporations. While as of March 31, 1987, 83 MLPs had been formed since 1981, it is far from certain that a wholesale shift from the corporate to MLP form of business is imminent.

The formation and operation of MLPs involves cash distribution requirements, front-end tax charges, and a loss of management control that would be objectionable to much of the corporate community. Though MLPs are criticized as an example of ad hoc corporate integration, in fact, do-it-yourself integration has long been available to the corporate sector though the use of debt and tax-exempt financing.

IMPACT OF MLP FORMATIONS ON FEDERAL TAX REVENUES

Potential Revenue Loss

As a separate entity, the corporation is subject to taxation on its earnings. In a dual corporate-shareholder system of taxation, corporate earnings are again fully taxed when they are distributed to an individual shareholder. In contrast, an MLP does not pay an entity-level tax. Its earnings are subject to tax at the unit holder level whether or not actually distributed, but the earnings are not taxed a second time when actually received by the unit holder. Critics of current-law tax treatment argue that an MLP cannot be distinguished in substance from a corporation and that this ability to avoid entity-level tax therefore reduces the combined tax on corporate earnings. Consider the following example comparing the situation before and after enactment of the Tax Reform Act:

The maximum individual tax rate was 50 percent and will be 28 percent while the maximum corporate tax rate was 46 percent and now is 34 percent. A corporation and an MLP each have \$100,000 of taxable income. Compare the after-tax results to the individual investor.

	<u>Old Law</u>	<u>New Law</u>
<u>Corporation</u>		
Earnings	\$100,000	\$100,000
Corporate Tax at Top Rate	(46,000)	(34,000)
Net Available for Dividends	\$ 54,000	\$ 66,000
Personal Tax at Top Rate	(27,000)	(18,500)*
Net Investor Return	\$ 27,000	\$ 47,500*
	=====	=====
<u>Partnership</u>		
Earnings	\$100,000	\$100,000
Personal Tax at Top Rate	(50,000)	(28,000)
Net Investor Return	\$ 50,000	\$ 72,000
	=====	=====
Incremental After-Tax Return to a Partnership Investor	\$ 23,000	\$ 24,500*
	=====	=====

(*Rounded)

- 4 -

The example clearly illustrates the potential tax savings (\$23,000 under prior law and \$24,500 under current law) available to an individual investor in an MLP compared to an individual shareholder in a corporation. However, this approach oversimplifies the potential impact of MLPs on Federal tax revenues, for at least two reasons. First, the example assumes that the corporation pays tax on all of its income at the highest corporate rate. In fact, many corporations do not pay tax at that rate. Through the use of debt, incentive credits, and other tax and financial planning, many corporations actually pay tax at a much lower effective rate. Second, the illustration assumes that 100 percent of the corporation's after-tax earnings are immediately distributed as dividends and are taxed at the highest marginal individual rate. This assumption, likewise, is questionable because (1) corporations typically retain a significant portion of their earnings for reinvestment, and (2) not all recipients of dividends pay tax, at least not at the highest individual rate. Tax-exempt institutions such as pension funds, for example, pay little or no tax on their dividend or capital gain income and are important investors in the corporate marketplace.

Realistic Revenue Impact

Our purpose in discussing revenue impact is not intended to provide a revenue estimate of a change in the tax treatment of MLPs. The ultimate responsibility, expertise and information to do this belongs to the revenue estimators at the Joint Committee on Taxation and the Treasury Department. Rather, the purpose of this discussion is to raise some issues to be considered in making these estimates, to provide new information, and to present some of the factors that the public debate may have overlooked in arguing that MLPs cause a significant drain on revenues. Careful analysis of the tax consequences associated with the formation and operation of MLPs indicates that the concern over a revenue loss, as compared to operating through a taxable entity, is greatly overrated and there may actually be a net revenue gain.

Factors in Assessing Revenue Impact

A number of factors must be considered in assessing the revenue impact of MLPs. At first glance, it is tempting to conclude that MLPs involve a revenue cost to the U.S. Treasury because a two-tiered tax levied on corporations and the corporation's shareholders would seemingly raise more revenue than a single-level tax imposed only on the investors or owners of a partnership. More specifically, identifying the revenue impact of MLPs necessitates answers only to the following questions:

- o How much revenue presently is collected at the investor level from MLP unit holders?
- o How much revenue would be collected first at the entity level and again at the investor level if a dual-level of tax were imposed on MLPs analogous to the present law tax treatment of corporations and shareholders?

In comparing the answers to these two questions, it is not obvious that a dual level of tax would collect more revenue than current law treatment of MLPs because, as explained below, not all of the income generated in the corporate sector is subject to tax at both the corporate and shareholder levels. In fact, some corporate income is distributed to tax-exempt organizations in the form of deductible interest and is, therefore, not taxed at all. Thus, it is doubtful whether applying an entity-level tax to MLPs would result in full taxation of MLP income at both the entity and investor level. While it is possible that the revenue cost associated with MLPs might be more significant if a massive shift from the corporate form of doing business were to develop, it is unlikely that such a shift will occur.

A revenue estimate based upon an assumption that the MLPs will become subject to a two-tier tax must assume that some portion of gross income of the entity will be taxed at the 34 percent corporate or entity rate and that some portion of the amount remaining after payment of entity-level federal and state taxes will be distributed to investors and taxed again at the recipient level. In order to compare the present level of tax revenue collected from MLP investors

- 5 -

with the revenue collected under a dual system that would treat MLPs "like corporations," there are at least four items for which estimates must be made:

- o The number of entities that would operate as MLPs as opposed to corporations assuming no change in the law, and the tax revenue collected from the investors.
- o The percentage of gross income that would be subject to tax at the entity level under the proposed change in law.
- o The percentage of income that then would be distributed to investors.
- o The percentage of that income that would be taxed to the recipients of the distributions.

These questions are difficult to answer because they raise a series of "what if" issues. Still, some tentative answers can be drawn from the manner in which the current tax system operates at the corporate and shareholder levels.

Number of MLPs

We were able to identify 83 MLPs that were publicly traded as of March 31, 1987. See Appendix D to the accompanying report. While it is impossible to estimate with any precision the number of MLPs that will be created within the next several years, the question really becomes whether there is a reason to suspect that a significant growth in the MLP sector will occur. It is our belief that while the number of MLPs will continue to grow, the number of MLPs as a percentage of all publicly traded entities should not be significantly greater than what it is today. See Section VI of the accompanying report. Even if there would be a significant increase in the portion of total income earned by MLPs, the following discussion indicates that it is unlikely that there would be a large loss in Federal tax revenues.

Corporate Level Tax

If MLPs are treated as taxable entities, i.e., "like corporations," will there be a substantial increase in corporate or entity-level revenue collections? While there may be some increase, a significant revenue increase depends on the further assumption that a large portion of revenues of corporate entities are fully subject to a 34 percent corporate tax at the present and that most MLP income escapes corporate-level tax. Neither of these assumptions is valid today. The primary reason that the first assumption is not valid is that the corporate tax is reduced by interest deductions generated by borrowing. The primary reason that the second assumption is not valid is that a large percentage of MLP units have been retained by the corporate sponsors and the earnings on those units are, therefore, still subject to a corporate level tax.

Debt substitute -- Many corporate transactions, including leveraged buy-outs, make extensive use of borrowing. Businesses are willing to borrow to such an extent for several reasons, but a major factor is highly leveraged acquisitions reduce corporate taxes. The tax benefits associated with debt financing reduce its net cost and make debt less costly than equity financing.

From the U.S. Treasury's perspective, debt financing can cause a net loss of tax revenue. This is because income of the borrower, which is paid out in the form of interest expense, is "sheltered" from taxation by the deduction for interest, but there is not necessarily a corresponding increase in taxable income to, and tax paid by, the lender. For example, the debt financing can be, and very often is, provided by tax-exempt institutions such as pension funds, or other lenders that are able to shelter their taxable income through the use of special deductions and incentive credits.

MLPs are very often used as a substitute for conventional-debt financing. Indeed, the evidence suggests that this is the predominant use of MLPs. Equity raised from the limited partners is used instead of debt financing to acquire new assets or it substitutes for debt that the corporate sponsor would

- 6 -

otherwise have incurred by pledging its assets. In other cases, equity raised when the MLP is formed is used to reduce corporate debt that is secured by assets that are transferred to the MLP by the corporate sponsor. In all of these instances, the MLP income that is allocated to the unit holders should be properly viewed as income that would have been paid by the corporate sponsor to third-party creditors. The revenue implications of this fact are important.

Instead of paying interest to tax-exempt or low-tax rate creditors, the corporate sponsor has, in effect, allocated income to taxable, individual unit holders. Thus, it is likely that there is an increase in revenues to the U.S. Treasury. At the very least, tax revenues are unaffected by the substitution of the MLP vehicle for conventional debt financing. Revenues are certainly not adversely affected.

While MLPs can and do borrow, the facts show that MLPs rely primarily on equity financing. MLPs listed in Appendix C of the accompanying report had debt equal to only 21 percent of their market value as of the end of 1986. The 15 largest MLPs had a debt-to-capital ratio of 16 percent as of the end of 1986.

MLP units retained by corporate sponsors -- The argument that the use of an MLP avoids all corporate-level tax assumes that all units are held by individual shareholders. The empirical evidence as of March 31, 1987, shows that, in fact, a large percentage of MLP units are still held by the sponsor corporations. Nearly 70 percent of the value of all MLP units identified as of March 31, 1987 are still held by the sponsor corporations. Thus, the income allocated to 70 percent of those units is subject to tax at the corporate level and is subject to the two-tier tax to the same extent as other corporate income. Based on this, it seems reasonable to expect that, as MLPs are formed in the future, a substantial portion of their income will still be subject to the two-tier system of taxing corporate income.

Income Distributed by Publicly Traded Corporations

Even under the two-tier tax system, all corporate earnings are not currently taxed twice, once at the entity level and again at the shareholder level. This is because a significant percentage of corporate earnings are retained for internal financing purposes. In fact, about 50 percent of corporate earnings were distributed to shareholders over the 1980-1983 period. (Statistical Abstract of the United States, 1985, p. 532.)

MLPs also retain some of their earnings and could retain all of them, but in either case the unit holders pay the tax. The important point is that if corporate retained earnings are compared with the earnings of an MLP the difference in revenue is not between a two-tier tax and a single tax, but is the difference between the corporate tax rate and the individual rate.

Taxability of Distributions -- The next issue is whether the approximately 50 percent of corporate earnings that are distributed are taxed to the shareholder at a high rate. The answer is that a significant percentage are not. Distributions to individual shareholders are, in general, subject to tax, but not all dividends are taxed at the top individual tax rate. In 1983, for example, 58 percent of dividend income received by individuals was reported on returns having less than \$75,000 in adjusted gross income. As an illustration of the marginal tax rate paid by these dividend recipients, about 65 percent of those in the \$50,000 to \$75,000 bracket of adjusted gross income paid tax at less than a 28 percent marginal rate. (IRS Statistics of Income Division, Individual Tax Returns 1983, Washington, D.C., November, 1985, pp. 84-86.) A significant portion of corporate distributions, however, are also made to tax-exempt shareholders who do not pay a second tax. According to Federal Reserve System Flow of Funds data, for example, tax-exempt institutions and insurance companies owned about 25 percent of corporate equity in 1980. (King and Fullerton, The Taxation of Income from Capital, National Bureau of Economic Research, 1984, p. 240.) Finally, corporate shareholders are entitled to exclude 80 percent of the dividend from taxable income.

- 7 -

MLP units, other than those retained by the corporate sponsors, are held as an investment almost exclusively by individuals largely because institutions effectively cannot invest in MLP units. A significant percentage of the equity of publicly traded corporations is held by tax-exempt institutions such as pension funds and charitable organizations. MLP units are not held by these organizations. Therefore, while partners in MLPs must report MLP taxable income currently without the benefit of any special exclusions or exemptions, many shareholders of publicly traded corporations do not pay tax on the dividend income they receive.

Inability to Shift Appreciation Outside Corporations

Another asserted revenue impact of MLPs is that they can be used to transfer assets outside the corporate entity so that appreciation or income with respect to those assets will escape corporate-level tax and will be taxed only once at the shareholder level. A careful analysis of the tax consequences associated with such a transfer shows, however, that there normally is an acceleration of tax revenue when the MLP units are transferred to noncorporate persons.

The accompanying report describes the tax consequences associated with a transfer of assets outside of the corporate entity for each MLP type. (Appendix A of the accompanying report describes these MLP types in additional detail.) As is described in each case, the formation of the MLP may be tax free because the assets of the MLP are still in corporate solution in the form of partnership units held by the corporate sponsor. Any distribution of the units or sale of the units by the corporate sponsor will be taxed to the corporate sponsor. The Tax Reform Act of 1986, by repealing the General Utilities doctrine, makes this tax very significant and impossible to avoid.

ECONOMIC ROLE OF MLPs

Introduction

Though MLPs are criticized by some as a device to avoid the corporate income tax, excessive attention to this criticism is open to question for two reasons. First, as illustrated above the formation of MLPs does not appear to result in a substantial erosion of the Federal corporate tax base. Secondly, the criticism overlooks the important fact that MLPs play a positive and beneficial role in the U.S. economy. The debate on the Tax Reform Act of 1986, stressed the need to improve economic efficiency, especially the productivity and use of the nation's capital stock. Indeed, the increase in effective tax rates on some forms of new investment under the Act was rationalized by a "level playing field" argument. Advocates of tax reform contended that any adverse effect from higher taxes on capital spending would be offset by a more effective and efficient use of the nation's capital stock. "However measured, the higher cost of capital to corporations will reduce incentives to invest. But this effort will be offset by the increased efficiency in the use of capital." (Aaron, Henry J., "The Impossible Dream Come True: The New Tax Reform Act," The Brookings Review, Winter 1987, p. 7.)

Consistent with this efficiency theme, MLPs can be viewed as a form of business organization that is good for the economy, one that increases national output by improving the allocation and use of the economy's resources. In particular, MLPs have four desirable characteristics:

- o MLPs provide an incentive to distribute or pay out to investors cash that might otherwise be invested in a less economical fashion;
- o MLPs contribute to a more efficient allocation of investment capital by enabling assets to be valued on the basis of their expected income or returns;
- o MLPs provide the MLP-intensive sectors of the economy with a source of capital comparable to that which the corporate sector acquires through internal finance or access to pension funds and other tax-exempt entities; and
- o MLPs improve liquidity and reduce the risk of bankruptcy by curtailing the level of debt in the economy.

Distribution Incentive

Over fifty years ago, Adolph A. Berle and Gardiner C. Means, writing in The Modern Corporation and Private Property recognized that the corporate form of business organization was plagued by a problem they described as the "separation of ownership and control." More recently, Michael C. Jensen, Eugene F. Fama, and William H. Meckling have been in the vanguard of those corporate finance specialists who have analyzed the characteristics of the separation of ownership and control issue, or what is also called the "agency" problem.

Separation of Ownership and Control -- The essence of the problem is that the ownership of the typical, large, publicly traded corporation is distributed among a large number of shareholders. Even allowing for institutional ownership, none of these shareholders normally has sufficient voting power (in terms of number of shares owned) to control the corporation. Further highlighting the situation, the typical shareholder normally views his role as that of an investor, and probably has no interest in managing the corporation.

In recognition of this dilution of ownership, a cadre of professional corporate managers has arisen to occupy the void created by shareholders who are either unwilling or unable to manage a large corporation. But according to a recent report of the President's Council of Economic Advisers, these professional corporate managers do not necessarily have any significant ownership interest in the corporations they manage. They view themselves as managers, not as investors or owners.

Thus, publicly traded corporations tend to be characterized by a separation between investors and managers, i.e., between owners and those charged with operating the corporation.

On one level, the separation of the ownership and management functions can be viewed as a salutary occurrence in that it creates mutual benefits by allowing shareholders to diversify their investment portfolios and professionally qualified managers to run the business. But the separation may also create difficulties because, according to those who have studied the "agency" problem, the two groups may not have congruent or identical interests.

Proponents of this view, note that the shareholders or owners of a corporation are interested in the security, income maximization, and appreciation of their investment. Corporate managers, functioning as the agents of the investor-owners, probably share these interests of the owners, but the managers may have their own independent interests as well.

Corporate management, for example, may be interested in a program of acquisitions, increased investment, and general business expansion, a strategy designed to maximize the overall size, but not necessarily the profitability of business operations. Critics of management behavior note that some corporate managers may seek to expand a firm beyond its optimal size in order to increase the resources under management's control (an aggrandizement motive) or because the compensation of corporate officers may be directly related to the size and sales growth of the corporation.

Free-Cash Flow Problem -- While this agency conflict between shareholders and management may exist in any large corporation, it can be particularly troublesome in those industries or sectors that generate substantial cash flows, but have modest growth prospects for reinvesting that cash, what some have described as a free-cash flow problem. If the growth and expansion of an industry is constrained by a static or shrinking market (perhaps because demand for the industry's product or service is not growing) the corporate managers in that industry may be confronted with difficult decisions on how to reinvest the corporation's earnings.

Many firms in the U.S. oil industry, awash with cash flow, responded by continuing their exploration and development (E&D) activity and/or pursued uneconomic mergers in other lines of business. (Jensen, Michael, "The Takeover Controversy: Analysis and Evidence," Midland Corporate Finance Journal, Summer 1986, p. 16)

The overspending on E&D and the unsuccessful diversification program in the oil industry illustrate one aspect of the agency conflict between shareholders and managers, what has been characterized as the "free-cash flow problem."

"Free-cash flow" is defined as cash flow in excess of that required to finance all projects having a positive net present value when discounted at the firm's cost of capital. In Jensen's view, "conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free-cash flow. The problem is how to disgorge the cash rather than investing it below the cost of capital or wasting it on organization inefficiencies." (Jensen, Michael C., "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," American Economic Review, May 1986, p. 323).

The oil industry is not alone in facing the free-cash flow problem. "Tobacco firms face declining demand due to changing smoking habits but generate large free-cash flow.... Forest products is another industry with excess capacity. Food industry mergers also appear to reflect the expenditure of free-cash flow. The industry apparently generates large cash flows with few growth opportunities." (Jensen, "Agency Costs" p. 328)

MLPs as a Response to the Cash-flow Problem -- MLPs are one solution to the free-cash flow problem identified by Jensen. MLPs provide managers with an incentive to "disgorge the cash" because, to facilitate the sale of MLP units, unit holders must be promised a minimum cash return on their investment. Admittedly, this payout policy may be partially motivated by tax considerations since the unit holders are taxable on their share of the partnership's earnings, whether those earnings are distributed or not. Thus, unit holders may demand some cash payout to satisfy their tax liability on the earnings of the MLP. MLP organizers, however, according to the cash-flow argument, also recognize the concern of unit holders that the return on their investment may be dissipated through unprofitable investments made by those managing the MLP. As a consequence, MLP managers generally agree to pay out a large proportion of the cash flow generated by the investment to the unit holders. Any cash flow that is retained or "held back" is typically done so to provide a cushion to finance future distributions if the expected cash flow from the investment does not materialize. This avoids the need to reduce future distributions in response to disappointing earnings.

Improved Allocation of Investment

MLPs improve the efficiency of the capital market by directing investment capital towards its most productive use. For example, MLPs are a desirable form of business organization in the oil and gas industry because they permit the basic underlying assets to reflect their maximum value. In contrast, the same assets may be undervalued when held in a corporation.

The free-cash flow theory helps explain the higher valuation. According to the theory, oil and gas properties held in corporate format may be valued below their earning capacity because of investor concern that part of their return will be wasted on nonproductive investments, rather than paid out to the owners. In its study of corporate control, the President's Council of Economic Advisers observes that a similar kind of undervaluation may exist with respect to real estate used for other than its best purpose.

"A retail chain may, for example, possess real estate that is more valuable as office sites than retail outlets. Although the retail chain may be well managed, if the company announces that it will not sell its real estate or put it to any use other than retailing, then the market has little incentive to value the firm's real estate at its current market price." (Economic Report of the President, 1985, p. 198)

Thus, allowing certain assets to be held by an MLP produces an important economic benefit. MLPs improve resource allocation by ensuring that the earnings on an investment are distributed to the unit holders. The Treasury Department's Assistant Secretary for Tax Policy, J. Roger Mentz, in discussing corporate-shareholder integration, has also noted the proclivity of some corporate managers to retain funds for reinvestment. "Some [corporate managers] may also be concerned that integration in the form of dividend relief would force larger distributions of corporate income and thus reduce

the capital available to corporations for reinvestment." (emphasis added) (Mentz, J. Roger, "Statement Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives," June 9, 1986, p. 14)

Because the earnings of an MLP are distributed, MLPs help prevent the cash flow from being invested in unproductive projects. According to the agency view of corporate-shareholder relations, the investors are likely to reinvest the money more productively than if the decision is left to the corporate managers, who may not have the same interests as the shareholders.

Source of Investment Capital

MLPs are concentrated in certain sectors of the economy, such as real estate, oil and gas, and the timber industry. The popularity of MLPs in these areas of economic activity is attributable, at least in part, to their success in solving the free-cash flow problem and improving the allocation of investment capital. Since most earnings are distributed to the unit holders, MLPs avoid the problems and mistakes that may confront these "wasting assets" when they have been held in corporate form. Thus, MLPs serve as an important source of financing for those sectors of the economy in which the corporate form of business organization may not be suitable.

Retained earnings, debt finance, and tax-exempt financing are recognized as legitimate vehicles for avoiding the full impact of the income tax at both the corporate and shareholders levels in those types of business activities in which the corporate form is the most appropriate vehicle. These sources of financing, however, are not readily available to the MLP sector. As noted earlier, the requirement for minimum cash distributions means that internal and debt finance are usually not possible. Tax-exempt organizations, moreover, do not normally invest in MLPs because of possible exposure to the tax on unrelated business income. Thus, MLP-intensive sectors of the economy generally cannot rely on tax-exempt entities as a source of financing. Nor, because of the need to distribute their cash flow, do MLPs make extensive use of internal or debt finance.

Consequently, the MLP vehicle provides a source of financing that, like earnings retention, debt, or tax-exempt financing in the corporate sector, subjects the income to a single level of taxation. Just as the corporate sector seeks sources of financing in which the dual corporate-shareholder taxes are avoided, MLPs provide a parallel opportunity for those sectors of the economy in which the corporate form may not be suitable.

Reduced Use of Debt Finance

MLPs increase liquidity and reduce the risk of bankruptcy by curtailing the amount of debt in the economy. This is a significant contribution given the increasing reliance on debt in the corporate sector. In order to successfully market MLPs, unit holders are usually assured a minimum in cash flow from the investment. Since interest payments would reduce that cash flow, MLPs have relied primarily on equity finance and avoided heavy debt commitments.

Appendix C, in the accompanying report, which shows the proportions of debt to book capital for selected MLPs, illustrates the generally substantial use of equity rather than debt. On an aggregate basis, the MLPs listed in the table had debt (\$6.6 billion) equal to 21 percent of their market value (\$31.2 billion) as of the end of 1986. Alternatively, the 15 largest MLPs had a debt-to-capital ratio of 16 percent as of the end of 1986.

In addition to relying mainly on equity finance, MLPs reduce the aggregate level of debt in the economy since the proceeds from an MLP issue are often used to extinguish debt held by the general partner or to purchase property that might otherwise be debt financed. This point is illustrated in Appendix D, which shows that in 1986, virtually all of the \$2.5 billion of capital that was raised for the listed MLPs was used to buy property or extinguish debt. (In many of the oil and gas MLPs, no new capital was raised).

STATEMENT
OF
JAMES R. MOFFETT
FREEPORT-MCMORAN INC.
TO THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 30, 1987

Mr. Chairman and Members of the Subcommittee:

I am James R. Moffett, Chairman of the Board and Chief Executive Officer of Freeport-McMoRan Inc. (FMI). I appreciate this opportunity to present my views on the subject of master limited partnerships (MLPs) and to provide the Subcommittee with information regarding FMI's own experience with master limited partnerships.

FMI is a diversified natural resources company which is involved in the exploration, development, mining, production, and/or processing of a variety of minerals including sulphur, oil and gas, gold, copper, silver, uranium, phosphates, and geothermal energy. At the present time, FMI conducts its oil and gas business through a master limited partnership, Freeport-McMoRan Energy Partners Limited, in which it owns approximately 75 percent of the partnership interests. In addition, FMI conducts its sulphur and fertilizer chemicals (both phosphate-based and nitrogen-based) mining and processing businesses, its geothermal energy business, and its uranium recovery technology business in another MLP, Freeport-McMoRan Resource Partners, Limited Partnership, in which it owns approximately 72 percent of the partnership interests. These partnerships were formed by FMI in April 1985 and June 1986, respectively. In each case, FMI and its affiliated companies contributed the pertinent assets and businesses to the MLP and then sold a portion of the interests in the partnership to the public in a taxable transaction.

For FMI, MLPs mean --

An essential source of capital.

A substantial enhancement of the value of FMI stock.

Significant growth of the company and expansion of its asset base.

The source of substantial, additional dividends for FMI's shareholders.

Larger, not smaller, federal income taxes.

Utilization of the partnership form of conducting business has been a traditional and long-standing practice in the natural resources industry. Partnerships provide a means of obtaining the funds needed for the conduct of the businesses and spreading the risks that are inherent in natural resource exploration, development, and production. FMI's adoption of the MLP form of conducting business for its oil and gas, sulphur, fertilizer chemicals, geothermal energy, and uranium recovery technology businesses was simply the extension in the context of today's capital markets of the traditional partnership form of doing business in the natural resources industry.

FMI's MLPs, however, have served not only the traditional purpose for which partnerships have been used in the natural resources industry -- raising the capital that is needed to carry on and expand the business -- but they also have provided the means for a substantial enhancement of the value of FMI's shareholders' investment in the company. Prior to formation of the MLPs the market was undervaluing FMI's assets and businesses and hence its stock. By forming and marketing interests in the MLPs, FMI countered this undervaluation. Since the end of 1984, the aggregate market value of FMI's common stock has increased by 47 percent.

Here's how FMI's MLPs have worked to substantially enhance the value of its stock for the benefit of its shareholders. Experience has shown that the marketplace often fails to adequately focus on the underlying value of a company's businesses and assets and, thus, it undervalues the company's stock. This is what was happening in FMI's case. The initial sale of approximately 15-20 percent of FMI's businesses to the public through interests in MLPs has permitted the capital markets to separately focus on and evaluate the underlying assets of, and the separate businesses carried on by, the MLPs. The marketplace's valuation of the MLP interests which are held and traded by the public provides the basis for valuing the entire business conducted by each MLP. If those businesses were still conducted in wholly owned subsidiaries of FMI as had been done in the past, the opportunity for separate market valuation wouldn't exist. As a result, those businesses and assets, as well as FMI's stock, still would be undervalued. FMI's conduct of its businesses through MLPs, however, has somewhat mitigated this market myopia.

These significant economic, non-tax benefits to FMI and its shareholders have been obtained without any tax cost to the federal Treasury; indeed, federal revenues have been increased because of FMI's MLPs. One of the most frequent charges that critics of MLPs make is that they will result in the "disincorporation" of America and the loss of tremendous amounts of federal revenues in the process. Both of these charges simply do not stand up under scrutiny. First, after the 1986 Tax Act, the tax cost of completely disincorporating existing businesses and transforming them into MLPs in most cases is prohibitive. Second, as FMI's own experience demonstrates, to the extent MLPs are used as a means of raising capital, as partnerships traditionally have been in the natural resources industry, there is no significant revenue loss associated with the MLPs and there may well even be revenue gains.

In 1987 FMI expects to pay 50 percent more federal income tax as the result of conducting its natural resources businesses through MLPs than it would have paid if it had raised the same amount of capital by the traditional means of debt financing.

It must be remembered that FMI remains fully taxable with respect to the approximately 75 percent interest it continues to own in each of its MLPs. It is true that FMI is not taxable on the approximately 25 percent of the income from the MLPs which is earned by the public holders of the partnership interests. That result, however, would not be significantly different if those persons had loaned the money to FMI for the conduct of its businesses.

The whole concern directed toward MLPs about revenue loss and disincorporation fails to recognize a fundamental characteristic of the conduct of business in America today. If the capital funds needed by a corporation to carry on and expand its business are not obtained through the sale of partnership interests in an MLP, those funds will

be obtained in most cases by debt financing. The interest deduction in the case of debt financing means that no corporate income tax is imposed with respect to the great bulk of the income earned by funds provided through the debt financing; it is only the incremental earnings on the capital above the cost of capital that bear any corporate income tax.

The single level of taxation of partnership income and the interest deduction allowed with respect to borrowed funds means that the return on the capital in each case -- partnership capital in one, debt-financed capital in the other -- essentially bears only one level of federal income taxation. There is little corporate tax on that income. The only significant level of taxation is at the level of the recipient of the partnership income or the interest.

Moreover, as a result of placing its natural resources businesses in MLPs, FMI has grown and expanded its natural resources base of assets and is paying more federal income tax today than it would have been had it used debt financing to obtain the needed capital funds. Since the end of 1984, the book value of FMI's assets, after reflecting the SEC-mandated write-down of oil and gas assets, has increased by over 39 percent. Excluding that write-down, FMI's assets have increased by 54 percent. Thus, although FMI has placed most of its business in MLPs, the MLPs have not resulted in the disincorporation of FMI. Rather, MLPs have allowed FMI to expand and grow, to increase its natural resources reserves, and to become a stronger company.

It is unlikely that FMI could have obtained through debt financing the amount of capital funds it has been able to obtain through the sale of partnership interests in its MLPs. It also would not have been practicable for FMI to obtain these capital funds through the sale of FMI stock. As previously indicated, the marketplace was already undervaluing FMI's stock. It had not focused on the underlying value of FMI's assets and businesses. To attempt to raise capital funds in that context by the issuance of additional stock would only have worsened the problem by further depressing FMI's stock price and thereby harming, rather than benefiting, FMI's shareholders.

MLPs provide another substantial benefit to FMI and its shareholders. FMI has been able to distribute to its shareholders in excess of \$100 million of dividends in the form of partnership interests in the MLPs. Not only has this been an obvious benefit to FMI's shareholders but, in addition, it has benefitted the federal Treasury because FMI's shareholders have received \$100 million of additional taxable dividend income. The distribution of interests in its businesses to FMI's shareholders would not have been possible if those businesses were conducted in corporate form because it would have caused the deconsolidation of those companies for tax purposes.

Finally, some people have argued that MLPs are different for tax purposes than other partnerships either because they have a large number of partners or because the partnership interests are readily saleable. Neither of those arguments stands up upon analysis and scrutiny. No rational basis exists for taxing MLPs differently than other partnerships; if MLPs were taxed as corporations, all partnerships would have to be taxed as corporations.

The fact that a limited partnership has many partners does not change the relationship among the partners to anything other than a partnership relationship. No difference exists between the nature of the relationship a limited partner has in and to a partnership in which there are four limited partners and one in which there are 4,000

limited partners. In neither case is a relationship of the limited partner to the partnership and the other partners the relationship of a shareholder to a corporation. Moreover, and very importantly, the number of limited partners does not change the fact that there are one or more general partners who have unlimited liability for the debts and acts of the partnership; that fundamental characteristic is not present in a corporation.

Similarly, the fact that a partner can easily sell his interest in a partnership does not alter or transform that person's relationship to the partnership to something other than that of a partner and it does not change the partnership into something other than a partnership.

No rational line can be drawn between large and small partnerships or between partnerships, the interests in which are readily saleable, and those in which they are not. There is no way to outlaw big partnerships or readily tradeable partnerships for tax purposes without doing away with all partnerships. There is simply no meaningful distinction between the various types of partnerships for federal income tax purposes.

Partnerships, large or small, tradeable or not, represent a long-standing, traditional means of doing business in America, particularly in the natural resources industry. They provide a means by which businesses can raise the capital needed to carry on and expand their activities in the form of equity rather than debt. Whether the needed capital is obtained through debt financing or the sale of interests in MLPs, essentially only one level of taxation is imposed. Accordingly, the choice of one form of financing over the other does not significantly affect the federal tax revenues. Attacking MLPs on the basis that they will create a revenue loss is like tilting at windmills. It simply isn't the real world.

I would like to make one last point in closing. The U.S. suffers from a serious trade deficit and we as Americans are concerned about our ability to compete in the world marketplace. To be competitive, American business must devote its full attention to running and improving its businesses and creating new profit opportunities. To develop necessary operating strategies and plans for being competitive, American business requires certainty regarding its fiscal obligations. There has been major tax legislation in four out of the last six years. In my judgment, it's time for the Congress to stop this process and let American business get on with the job of becoming more competitive to regain its rightful place in the world marketplace rather than having to focus its attention on taxation and what Congress might be attempting to do to change the way we do business today. No other country subjects its industries to such uncertainty and distractions. In fact, other nations use their tax law to subsidize their industries so as to improve their competitive position in the marketplace.

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
PRESENTED BY
WALLACE R. WOODBURY

INTRODUCTION

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on behalf of the members of ICSC.

The International Council of Shopping Centers (ICSC) is the trade association for the shopping center industry with over 21,000 members. Membership includes developers, owners, retailers, lenders and all others having a professional interest in the shopping center industry. ICSC members represent most of the 28,500 shopping centers in the United States. In 1986 these centers generated \$20.3 billion in sales tax revenues and employed 6.9 million people.

The hearings concerning master limited partnerships are of particular interest to ICSC. Limited partnerships are the traditional entity employed for financing real estate transactions. Changes in the manner in which limited partnerships are taxed would have profound consequences for members of our organization.

ICSC supports the current system of taxation applicable to MLPs and limited partnerships. To the extent that Congress determines that special tax rules should apply to MLPs or other "pass-through" entities, we would strongly urge that a special exception to those rules be granted to real estate. The exception for real estate MLPs can be justified by the fact that investments in real estate have traditionally been made through limited partnerships and that such entities are not "disincorporating" to take advantage of the tax rate structure following the Tax Reform Act of 1986 ("TRA '86").

STATEMENT

1. Limited Partnerships and Real Estate

Limited partnerships have traditionally been used as the investment vehicle for real estate transactions. The principal advantage to the limited partnership is the flexibility it offers to investors. Some investors desire cash flow while other investors prefer investment appreciation. Special allocations, within the limitations of Code §704(b), permit investors to structure real estate investments to reflect economic realities.

Real estate MLPs have recently become popular investment vehicles. In contrast to pre-tax reform real estate tax shelter investments, these MLPs offer investors cash flow and high yields as opposed to deductions and losses. Tax-oriented limited partnership investments have been curtailed by extended depreciation periods, and the passive income and investment income rules of TRA '86. Congress has succeeded in forcing partnerships to highlight the economic as opposed to the tax

advantages of real estate investments. Real estate MLPs permit partnerships to retire debt and acquire property on a less leveraged basis.

The Treasury and a few other commentators have proposed that Congress tax MLPs as corporations. The principal justification for this tax treatment is that unless MLPs are taxed as corporations, significant amounts of revenue will be lost as corporations disincorporate and switch to the partnership form of business. This rationale would not apply to real estate MLPs.

The real estate industry should not be compared with businesses that disincorporate and form MLPs to avoid double taxation. The real estate industry is not avoiding taxes through the use of MLPs and contributing to the erosion of the corporate tax base. Real estate investments were conducted through limited partnerships before tax reform and continue to be conducted as limited partnerships after tax reform.

In addition, taxing real estate MLPs as corporations would have a substantial negative effect on the real estate industry. Yields on real estate MLPs would be significantly lower due to the tax. Investors would have little incentive to invest in real estate. Further changes to the partnership tax rules are unnecessary and may have the unintended consequence of reducing capital investment in the United States. Real estate transactions would again become increasingly leveraged as the ability to raise equity capital from a large number of investors would be curtailed.

In the event Congress decides to tax MLPs as corporations, a special exemption should be granted to entities involved in real estate. These activities have traditionally been conducted in noncorporate form. Alternatively, only those limited partnerships listed on a public exchange should be taxed as corporations. Taxing all MLPs as corporations would economically cripple many legitimate publicly issued partnerships.

The proposal that partnerships allocate tax losses only to those partners with unlimited liability ignores the economic effect of a partnership's losses on the value of a limited partner's interest. As long as loss allocations have substantial economic effect (as set forth in code §704(b) and the regulations thereunder) limited partnerships should be permitted to allocate losses to limited partners. The loss of capital on the part of a limited partner surely qualifies as bearing the risk of economic loss in a partnership investment.

2. Passive Loss Rules and MLPs

The passive loss rules were enacted in TRA '86 to encourage taxpayers to make investment decisions based on economic merit rather than for tax considerations. Real estate MLPs are designed to provide investors with cash flow and high yields, not primarily with tax benefits. Treasury has expressed concern, however, that income from MLPs may be used by taxpayers to offset passive losses. Since real estate MLPs are not formed to avoid the passive loss rules, the issue of whether MLP income is passive involves tax policy considerations other than the proper classification of MLPs for tax purposes.

Concern that real estate MLPs may eviscerate the passive loss rules is unfounded. As the cash flow from most MLPs offer investors an 8-10% cash-on-cash return, and since the cash flow from most real estate limited partnerships is sheltered, taxpayers must generate substantial amounts of MLP passive income in order to offset small amounts of passive tax losses. The large amount of capital investment required to generate income to utilize a small amount of passive tax losses discourages taxpayers from using MLPs for that purpose.

3. Real Estate Pass-Through Entities

Congress may also give consideration to the creation of one pass-through entity for tax purposes. In such an event, ICSC would recommend that such an entity possess investment and tax characteristics as flexible as the partnership vehicle. Alternatively, given the special characteristics of real estate and natural resource investments, the creation of an entity with the flexibility of the partnership would be appropriate at least for such activities.

ICSC appreciates the opportunity to submit these comments and hopes that they are of use to you.

STATEMENT
OF
SANTA FE PACIFIC EXPLORATION COMPANY
ON THE MATTER OF
MASTER LIMITED PARTNERSHIP TAXATION

Santa Fe Pacific Exploration Company (Santa Fe) as managing general partner for Santa Fe Energy Partners, L.P. (SFP), an oil and gas exploration and production master limited partnership (MLP), appreciates this opportunity to comment on why MLP's should continue to be treated as partnerships for federal income tax purposes.

As background, SFP was formed in late 1985 in a rollout transaction wherein selected properties of Santa Fe Energy Company, the oil and gas operating company of Santa Fe Southern Pacific Corporation (SFSP), were contributed in exchange for limited partnership units. Additionally, a public offering of approximately twenty-two percent of the units was made. Approximately seventy-eight percent of the partnership interests were retained by affiliates of SFSP. The partnership was formed to provide greater access to capital markets and to enhance SFSP stockholder value by highlighting the oil and gas operations of the corporation.

Several reasons for taxing MLP's as corporations have been proposed by the Treasury Department: 1) the general revenue loss to the United States Treasury; 2) avoidance of the passive loss rules enacted in 1986; and 3) Internal Revenue Service administrative problems in collecting taxes from individual partners. Our comments on each of these issues are as follows:

Revenue Effect: Mr. Mentz advanced a proposal to tax MLP's as corporations that would improve revenues by only \$665 million over a five-year period; this is not a significant amount when viewed in the context of the federal budget or deficit. With regard to our specific partnership, SFSP companies currently hold an approximately 80% ownership interest. Corporate tax is therefore still paid on 80% of the partnership income. If the primary motivation for establishing SFP had been the avoidance of double taxation of corporation income, a significantly larger percentage of partnership units would have been issued to the public. The decision to do otherwise emphasizes the non-tax business reasons for establishing SFP (i.e., the raising of capital and the enhancement of SFSP shareholder value through increasing public awareness of its oil and gas operations).

Passive Loss Avoidance: Some concern has been noted by Treasury that classification of MLP income as passive income could circumvent the intent of recently enacted passive loss rules. On the other hand, MLP's may also generate losses which would be classified as passive. Should this issue truly be considered significant, it appears that Treasury currently has the authority to correct the matter through Regulations.

Administrative Problems: We do not believe that perceived administrative problems should dictate tax policy. Such problems can be handled much less drastically than by tampering with longstanding classifications that have been relied on by taxpayers and the capital markets for years.

In summary, SFSP has utilized the Master Limited Partnership as a vehicle for raising capital and to spotlight certain assets of our corporation. We firmly believe their tax status should not be altered.

SERVICEMASTER LIMITED PARTNERSHIP

Statement to the House Ways and Means
Subcommittee on Select Revenue Measures

On behalf of ServiceMaster Limited Partnership ("ServiceMaster"), I welcome the opportunity to provide testimony to the House Ways and Means Subcommittee on Select Revenue Measures in connection with the Subcommittee proceedings on the tax treatment of master limited partnerships ("MLPs").

My remarks are limited to the issues of changing the tax treatment for existing partnerships that converted from corporate form to partnership form in reliance on current law.

Summary

On December 30, 1986, ServiceMaster's predecessor, ServiceMaster Industries, Inc., converted its entire business from the corporate form of organization to the limited partnership form of organization.

ServiceMaster viewed the conversion to partnership form as advantageous for business and financial reasons. The partnership form more closely reflects the nature of ServiceMaster's business. Partnership form allowed an increase in the amount that senior management had at risk in the success of the business and thus is important in maintaining the dedication necessary in a service business. This risk exposure, as contrasted to corporate limited liability, distinguishes ServiceMaster from a corporation, in form and in substance.

As part of the conversion to partnership form, ServiceMaster Industries, Inc. liquidated under section 331 of the Internal Revenue Code. The liquidation was taxable at both the corporate and shareholder levels. The taxes paid by ServiceMaster and those estimated to have been paid by its shareholders total over \$70 million.

ServiceMaster and its shareholders incurred these costs in reliance on existing law regarding the classification of publicly traded partnerships and the repeated rejection by Congress and the Administration over the past five years of proposals to change that classification. Given the legislative record, particularly the rejection of the classification proposals and the repeal of the General Utilities doctrine making further conversions unlikely, ServiceMaster was entitled to believe that its conversion, effected at a substantial cost, would be respected and there would be no change in its tax treatment, especially when this cost accelerated tax revenue to the government and did not defer or lose revenue for the government.

Description of ServiceMaster:
Its Business and Management

ServiceMaster is an Illinois-based international service company which manages the housekeeping operations, the plant, maintenance, laundry and material management functions, and the food service operations in over 1,000 hospitals, 350 colleges, universities and school districts, and 100 major industrial facilities.

To obtain and retain its customers, ServiceMaster must establish a relationship of trust and confidence in which the people of ServiceMaster are constantly demonstrating that the

customer's business activities under ServiceMaster's management are more effective and productive because of ServiceMaster and the performance of its people. The very personal relationship which develops between the people of ServiceMaster and its customers makes ServiceMaster analogous to personal service companies which have found the partnership form of doing business preferable because it provides for partnership ownership and accountability among those responsible for delivering the service. Indeed, our very name conveys the personal service nature of our business.

Because ServiceMaster's business requires highly motivated manager employees that serve with the heart of an owner, ServiceMaster has attempted over the years to establish a broad base of employee ownership and to instill in its employees the attitude of being a partner in service to the Company's customers. At the present time, over 50% of ServiceMaster's employees participate in ServiceMaster's ownership purchase plan and over 70% of ServiceMaster employees participate as owners through the Company's profit sharing and retirement plan. At the executive level, ServiceMaster's senior managers have made major commitments to the purchase and ownership of equity in ServiceMaster. As a result, these executives do not have diversified portfolios and substantially all of their net worth is at risk in the success and growth of the Company.

ServiceMaster is thus a personal service company in which employee dedication, motivation and close identification with the Company's objectives are central to the Company's business. In the view of ServiceMaster's directors and management, ServiceMaster is a natural partnership and has enhanced its ability to serve its customers by converting to partnership form.

The Reorganization

Prior to December 30, 1987, the ServiceMaster enterprise was operated in a standard corporate form, with a parent company and several subsidiaries. On December 30, 1986, the company converted its entire business into partnership form. This was accomplished through the liquidation of the parent corporation and all of its subsidiaries. A holding partnership (ServiceMaster Limited Partnership) and an operating partnership (The ServiceMaster Company) were formed to receive ServiceMaster's assets and continue its business. Each of the two partnerships was organized as a Delaware limited partnership with a corporate general partner (ServiceMaster Management Company) and four individual general partners.

The four individual general partners of the ServiceMaster partnerships are: C. William Pollard, President and Chief Executive Officer; Robert D. Erickson, Executive Vice President and Chief Financial Officer; Charles W. Stair, Executive Vice President, Management Services; and Alexander Balc, Jr., Senior Vice President. As a general partner, each of these men has exposed his entire net worth to the risks of ServiceMaster's business. In addition, 15 senior managers are shareholders of the corporate general partner and have exposed substantially all of their personal net worth to the risks of ServiceMaster's business through contributions to it.

In light of the risks assumed by the individual general partners and the shareholders of the corporate general partner, ServiceMaster clearly does not resemble a corporation, where top management and large shareholders are not at risk.

The Tax Cost
of the ServiceMaster Reorganization

The conversion to partnership form involved a taxable liquidation of the corporations that made up ServiceMaster. The federal income taxes paid by ServiceMaster and those estimated to have been paid by its shareholders as a result of the liquidation total over \$70 million.

Stating the tax results of the conversion in the aggregate tends to disguise the tax impact in individual cases. No cash was distributed in the conversion to pay the substantial tax liabilities incurred by the shareholders. Many small shareholders (including employee-shareholders with holdings built up over years of service with ServiceMaster) had to borrow in order to pay tax liabilities which were substantially in excess of their annual cash incomes.

If ServiceMaster were taxed as a corporation, the substantial costs of conversion would be forfeited without recovery or benefit.

The Tax History
Relied Upon by ServiceMaster

In planning the conversion from corporate form to partnership form, ServiceMaster relied on the Congressional decision in the Tax Reform Act of 1986 to reject proposals to tax MLPs as corporations, while limiting future conversions by existing corporations through the repeal of the General Utilities doctrine.

The history of the classification issue is known to the Subcommittee but because of our reliance on it, we find it necessary to summarize the history briefly below.

A. Senate Finance Committee Study. The story begins in 1983, when the Senate Finance Committee staff completed the first phase of a project to review the rules for corporate taxation. The staff report questioned why publicly traded limited partnerships should not be taxed as corporations. Hearings were held on October 24, 1983, at which time the Administration opposed any change in the current law regarding classification of partnerships. The subject of corporate tax reform was then dropped as attention turned to the legislation which became the Deficit Reduction Act of 1984. The final staff report of the Senate Finance Committee was issued in May 1985. It did not recommend taxation of any partnerships as corporations on the ground that the Treasury Department was studying the subject.

B. House Ways and Means Committee Study in 1983-1984 (H.R. 4170). In the course of the House Ways and Means Committee's initial work on the Tax Reform Act of 1983 (H.R. 4170), an amendment was proposed for the taxation of publicly traded partnerships as corporations. However, this amendment was not considered at any length since H.R. 4170 did not reach the House floor in 1983. When consideration of H.R. 4170 was renewed in 1984, the Joint Committee staff proposed taxation of publicly traded partnerships for Ways and Means Committee consideration. Following the Ways and Means Committee hearings on H.R. 4170 in February 1984, the provision for taxing certain partnerships as corporations was dropped. Neither H.R. 4170 (as reported by

the House) nor the Deficit Reduction Act of 1984 included any provision which changed the current taxation of publicly traded partnerships.

C. 1984 Treasury Study ("Treasury I"). In November, 1984, the Treasury Department issued its tax reform study entitled "Tax Reform for Fairness, Simplicity and Economic Growth" (which eventually became popularly known as "Treasury I"). This study proposed that all limited partnerships with more than 35 limited partners would be classified as associations. This proposal met with strong opposition, including opposition from many Congressmen and Senators and from ranking members of the Administration. Treasury I did not receive the President's backing.

D. 1985 Treasury Study ("Treasury II"). In May 1985, with the President's support, the Treasury Department issued a revised tax reform study entitled "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (dubbed "Treasury II"). In Treasury II, the proposal for classifying limited partnerships with more than 35 limited partners as associations was dropped.

E. 1985 House Bill. In the summer of 1985, the staffs of the Joint Committee and the Ways and Means Committee prepared an alternative tax reform proposal to be used by the Ways and Means Committee for the mark up of a tax bill. Known as the "Rostenkowski Proposal", the House bill made loss pass-throughs a preference item but did not in any way suggest a change in the law regarding classification of limited partnerships. The House bill did contain a provision repealing the General Utilities doctrine. The House bill, H.R. 3838, was passed by the House on December 17, 1985.

F. 1986 Senate Finance Committee Action and Senate Bill. In early 1986, the staff of the Senate Finance Committee worked on a tax reform proposal for Committee Chairman Robert Packwood. In the final proposal, adopted by the Finance Committee on May 29, 1986, no reference was made to classifying any limited partnerships as associations. The matter had not been raised during the Finance Committee hearings on the bill and was not raised in the June floor debates on the bill in the full Senate. The Senate adopted the bill on June 24, 1986.

G. June 1986 Testimony by Assistant Secretary Mentz. On June 9, 1986, J. Roger Mentz, Treasury Department Assistant Secretary for Tax Policy, testified in hearings held by the Ways and Means Subcommittee on Select Revenue Measures on the taxation of pass-through entities. Mentz proposed that publicly traded limited partnerships be taxed as corporations.

H. Conference Action. The Conference Committee met from July 17 to August 16, 1986. It adopted the repeal of the General Utilities doctrine as proposed by the House. Once again there was no provision relating to partnership classification. In contrast to the proposal to tax MLPs as corporations, which was not incorporated in the Conference bill, various other proposals considered at the June Subcommittee hearings on the taxation of pass-through entities, including ones relating to regulated investment companies, real estate investment trusts, and the new real estate mortgage

investment conduits, were in fact adopted and incorporated into the final bill. The Conference Report was filed on September 18, 1986 and both Houses and the President subsequently approved the bill.

Thus, the 1986 Act, which adopted the most sweeping changes to the Internal Revenue Code since 1954, did not change the taxation of MLPs.

ServiceMaster relied on this history in making its decision to change from corporate to partnership form in 1986. It reasonably concluded that Congress was satisfied with the existing set of rules which differentiated both publicly traded partnerships and non-traded partnerships from corporations. This was certainly not a case of Congress being unaware of the issue; committee staff reports and Treasury papers had repeatedly raised the issue in one form or another over the previous five years. Yet Congress consistently rejected the proposals, and thereby allowed companies like ServiceMaster to believe that a corporation-to-partnership conversion would not be undone in the foreseeable future, particularly in light of the repeal of the General Utilities doctrine.

Conclusion

As a matter of fundamental fairness ServiceMaster's present classification as a partnership should remain in effect. ServiceMaster and its partners "played by the rules," paid the tax toll-charge for conversion to partnership form and its executives exposed themselves to personal liabilities. Accordingly, ServiceMaster deserves to retain its partnership classification.

Proposals have been made which would give existing MLPs only a limited period of transitional relief from corporate taxation. Any such limited relief would be inadequate in ServiceMaster's case because it would not compensate ServiceMaster's partners for the tax costs and other costs of the conversion. ServiceMaster believes that fundamental fairness requires that any change in the tax classification of MLPs not affect it.

C. William Pollard
President and Chief Executive Officer
ServiceMaster Limited Partnership

TESTIMONY OF ROBERT J. ST. LAWRENCE
ON BEHALF OF STANDARD PACIFIC, L.P.

Standard Pacific, L.P. ("Standard Pacific"), a limited partnership traded on the New York Stock Exchange, is opposed to the Treasury Department's proposal to tax publicly traded limited partnerships as corporations (the "Treasury Proposal"). Standard Pacific concurs with the testimony before this Subcommittee in opposition to the Treasury Proposal and in addition believes the Treasury Proposal would result in a particularly harsh result if applied to Standard Pacific.

Standard Pacific is a company primarily engaged in the homebuilding business in several states including California, Texas, Illinois and Washington. Its main activity is the construction and sale of single-family dwellings. In addition, the Company also has a smaller operation which manufactures and sells movable and acoustical office partitions. This activity occurs in California, Illinois, North Carolina, New Jersey, Texas, New York and Pennsylvania.

Standard Pacific was formed in December of 1986 as a successor to a corporation originally incorporated in 1961 as Standard-Pacific Corp. Standard-Pacific Corp and its shareholders relied on the well-established principles of partnership taxation in deciding to liquidate the corporation, to incur the substantial taxes due on such liquidation, and to continue to operate under partnership form. The transaction was first considered by the corporation's Board of Directors in the fall of 1985 and it was thereafter carefully studied for many months before being recommended to its stockholders. The transaction was overwhelmingly approved at a stockholders' meeting in the fall of 1986. The corporation complied with the tax law as in existence during 1986 and obtained tax rulings from the Internal Revenue Service on various aspects of the liquidation as well as a tax ruling on the status of Standard Pacific as a partnership for federal income tax purposes. Furthermore, the transition rules in the Tax Reform Act of 1986 delayed the repeal of the General Utilities doctrine until January 1, 1987 thereby allowing the liquidation of Standard-Pacific Corp to be accomplished under the old tax rules.

The liquidation of Standard-Pacific Corp caused the corporation to pay approximately \$23 million in federal income taxes and \$4.9 million in state income taxes. These amounts are for deferred taxes under the installment sale rules that otherwise would be taxed only over a period of many years and at lower rates than the 46% rate applicable in 1986. In addition to these corporate-level taxes, each stockholder of Standard-Pacific Corp whose shares were converted into Units of limited partnership interest in Standard Pacific became subject to capital gains tax on the difference between the value of the Units received by the stockholder in exchange for his common stock and the stockholder's tax basis in his stock. Standard Pacific estimates the income tax liability of the stockholders to be in the range of \$30 to \$60 million.

Apart from the federal and state income taxes, there were substantial costs incurred in liquidating Standard-Pacific Corp and setting up the business in partnership form. These costs total approximately \$1.5 million. In addition, Standard Pacific has now been incurring additional expenses in complying with

partnership law in the neighborhood of \$250,000 to \$350,000 per year.

In January of 1987, Standard Pacific completed a public offering of 1.77 million Units, \$40 million of the proceeds of which were distributed to its Unitholders in order to help them defray the tax cost of the liquidation of Standard-Pacific Corp. Many of the purchasers of Units in this offering were not former stockholders in Standard-Pacific Corp, but they did acquire interests in a partnership rather than a corporation. This public offering cost roughly \$3 million in underwriting fees and other expenses. As a result of the offering, the ownership interests of the initial Unitholders of course were diluted since the number of Units outstanding increased substantially.

Standard Pacific is owned by more than 10,000 Unitholders, the vast majority of whom are individuals who own relatively small blocks of Units. In addition, Units are held by various tax-exempt entities, including pension funds, Keogh plans and individual retirement accounts. The general partners of Standard Pacific are a corporation which serves as the managing general partner and a general partnership composed of three individuals and the corporate managing general partner.

The Board of Directors of Standard-Pacific Corp believed that the liquidation of Standard-Pacific Corp and the continuation of its business in limited partnership form would greatly enhance the economic value of the business to its owners. In particular, based on projected operations of the company, it was believed that operating the business in partnership format would maximize the business' substantial cash flow that could be distributed to its owners, thereby enhancing the value of their investment in the company. The recent experience of Standard Pacific has borne out these expectations. Distributions of cash to Unitholders during 1987 are anticipated to be roughly six times as great as the dividend distributions to the corporate shareholders during each of the last several years of the corporation's existence.

The Treasury Proposal is based on the assumption that a publicly traded limited partnership is just like a corporation. In Standard Pacific's case such an assumption is completely erroneous. There are three individuals who are in effect general partners in Standard Pacific. Under partnership law, these individuals are responsible for management of the company's business and are personally liable for the company's debts. This situation, of course, is totally incompatible with the corporate form where no individual is personally liable for the corporation's debts. In addition, Standard Pacific complies with all the various business and tax laws governing limited partnerships. As a result it is run like a partnership, taxed like a partnership and in every respect is a partnership.

For Congress to abruptly change the rules and tax Standard Pacific as though it were a corporation notwithstanding its organization as a partnership would be totally unfair. Standard Pacific incurred close to \$30 million in taxes and transactions costs as a result of its liquidation and its stockholders became liable for tens of millions of dollars in personal income tax liabilities. Although under the Treasury Proposal the government would collect both corporate taxes from Standard Pacific and

individual level taxes from the Unitholders, it has not proposed that the Treasury refund the tens of millions of dollars in taxes paid on the liquidation of Standard Pacific's corporate predecessor. Yet, the retention of such taxes coupled with the imposition of corporate level taxes on Standard Pacific amounts to double taxation of the grossest sort.

In addition, the public offering of Units whose proceeds were distributed to stockholders in order to defray part of their income tax liabilities diluted their holdings in the partnership. The new Unitholders also fully expected that Standard Pacific would continue to be taxed as a partnership and not as a corporation.

The tax costs arising out of the liquidation of Standard-Pacific Corp, the various transaction expenses, and the dilution occurring as a result of the public offering are all irreversible events. To change the rules of the game now and tax Standard Pacific as a corporation would be a tremendously unfair hardship on the company and its many Unitholders. The application of the Treasury Proposal to Standard Pacific would amount in effect to retroactive taxation due to the high tax costs already incurred by the company and its owners.

The Treasury Proposal also is discriminatory to Standard Pacific's Unitholders in another way. Standard Pacific has thousands of Unitholders, many of whom have small ownership interests of a hundred Units or less. It is extremely doubtful that many of these Unitholders would ever qualify or be in a position to invest in a private placement limited partnership. Such private placements are generally only available to sophisticated investors who meet certain net worth and income tests. Under the Treasury Proposal, partnership investment opportunities will still be available to the wealthy investor but will not be available to low and middle income investors who can not meet the requirements of a private placement partnership. Under current law, however, Standard Pacific Unitholders are entitled to be treated as limited partners in Standard Pacific and thereby share in the enhanced cash flow generated by the company's operations. Of course, the individual Unitholders are liable for their prorata share of partnership taxable income. Nevertheless, these individuals now have the opportunity to own an interest in a limited partnership and thus are able to participate in an investment vehicle heretofore reserved primarily for the wealthy investor.

Standard Pacific therefore strongly urges this Subcommittee to reject the Treasury Proposal. In the event, however, that a change in the law with regard to publicly traded limited partnerships must occur, Standard Pacific urges that an exemption or other transition rule should apply to it so as to avoid the de facto retroactive taxation that would otherwise occur. Standard Pacific also recognizes that there may be other areas of concern with respect to partnership taxation and it remains willing to work with the Subcommittee on technical corrections or other proposed changes to the tax law in this area.